Long Association with an Audit Client

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Examiner: P2 Audit Practice

The Auditing Practices Board Ethical Standard 3 was revised in October 2009 and addresses the issue of "Long Association with an Audit Client". It states that:-

"The audit firm shall establish policies and procedures to monitor the length of time that audit engagement partners, key partners involved in the audit and partners and staff in senior positions, including those from other disciplines, serve as members of the engagement team for each audit.
Where audit engagement partners, key partners involved in the audit, and partners and staff in senior positions have a long association with the audit, the audit firm shall assess the threats to the auditor's objectivity and independence and shall apply safeguards to reduce the threats to an acceptable level. Where appropriate safeguards cannot be applied, the audit firm shall either resign as auditor or not stand for reappointment, as appropriate" (ES 3 para. 5&6)

It goes on to say that the reason for this is that "self-interest, self-review and familiarity threats to the auditor's objectivity may arise. Similarly, such circumstances may result in an actual or perceived loss of independence".

It goes on to define long association as follows:

Engagement Partner	Non-listed clients	10 years
Engagement Partner	Listed Clients	5 years (with no return for 5 years)
Other Partners involved in audit (including Quality Control Reviewer)	Listed Clients	7 years (with no return for 5 years).

Probably the most significant consequence of ES3 is that it virtually mandates **partner** rotation in relation to listed clients. It should be noted, however, that audit **firm** rotation is not mandatory for any clients in Ireland or the UK.

Rotating the audit partner in the case of listed clients is usually not a problem for the firms concerned as nearly all listed clients are audited by "Big 4" firms and the remainder by substantial "mid-tier" firms. The rotation requirements for non-listed entities could, however, pose a problem for smaller practices and would – by definition – be impossible for single-handed practices to comply with. The guidance on Provisions Applicable to Smaller Entities (PASE) allows the term of office to continue beyond the 10 year deadline provided appropriate safeguards are put in place. There safeguards would typically include an independent quality control review and extensive documentation of the reasoning that informed the decision to maintain the audit.

The rationale behind mandating audit partner rotation for listed clients is that it prevents individual engagement partners (the ultimate signatories of the audit report) from becoming either too familiar/friendly with the client (familiarity threat) or becoming too dependent on individual clients as part of their client portfolio (self-interest threat). It is also believed that rotating partners periodically will help bring fresh perspectives to the audit and may help prevent an excessively predictable audit approach.

This, in turn, raises two questions. Firstly, is there any evidence that this correct? Secondly, if such evidence exists would it not make more sense to take this to its logical conclusion and to mandate auditor rotation?

The argument against mandatory audit firm or audit partner rotation is that auditing is a complex business and that, above all, it requires a thorough understanding of the client's business. This understanding, the argument goes, is enhanced by long association with the client as the partner/firm of long standing will be aware of how the client's business developed, of its history and culture, and of the characteristics of management and senior staff. All of this makes is easier to give well-informed advice to management and ultimately a better Audit Report.

There are two other more practical arguments against audit **firm** rotation. Firstly, in today's world effective auditing may require considerable investment on behalf of the audit firm in, for example, specialised audit software. Firms are less likely to make this investment if they feel that they will have to "rotate off" the client after a reasonably short period. Secondly, for listed companies there may be a shortage of firms to whom they can rotate. This is especially the case for companies who have use one firm as auditors and use another firm for certain reporting requirements under the US Sarbanes Oxley Act (SOX). Given that there are only four firms in the "Big 4" this could be a real problem. On the other hand "mid-tier" firms might see it as a chance to get a slice of the action.

The question of long association of with the audit client has also provided rich pickings for academics over the years. Even a cursory glance at the literature reveals papers going back as far as 1958[*]. However, the evidence from academic research is inconclusive. This is partly because of the difficulty of measuring the effectiveness of auditing. The (thankfully) relatively low numbers of manifest audit failures over the years means that academics have to use surrogate measures such as the level of discretionary accruals in order to try to measure auditor bias. For anyone interested in following up on this topic here is a sample of papers you might find interesting.

Bamber E. M. And L.S. Bamber 2009. Discussion of "Mandatory audit partner rotation, audit quality, and market perception: Evidence from Taiwan". *Contemporary Accounting Research 26 (2)*: 393-402

Boone, J.P., I.K. Khurana, and K.K. Raman, 2008.Audit firm tenure and equity risk premium. *Journal of Accounting, Auditing, and Finance* 23 (Winter): 115-140

Ghosh, A. and D. Moon 2005. Audit tenure and perceptions of audit quality. *The Accounting Review* 80 (2): 585-612

Stanley, J.D. and F.T. DeZoort. 2007. Audit firm tenure and financial resyatements: An analysis of industry specialisation and fee effects. *Journal of Accounting and Public Policy* 26: 131-159.

*McLaren, N.L. 1958 Rotation of Auditors. *Journal of Accountancy* 106 (July): 41-44