Audit Rotation
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Examiner: P2 Audit Practice

The idea that the auditor should be independent of his/her client has been a cornerstone of auditing for over a century. This idea underpins most pronouncements on ethics such as the International Ethics Standards Board for Accountants (IESBA) Code of Ethics (2009).

The same code identifies the "familiarity threat" as one of the main risks to the independence of the auditor. The Auditing Practices Board (APB) makes a similar point in Ethical Standard 1 (2011). The basic idea is that if an auditor is too familiar with a particular client s/he may be insufficiently sceptical about clients' representations or may not probe the client's business with appropriate assiduousness thus leading (possibly, inadvertently) to increased levels quality control risk and therefore detection risk.

An example of this might be deciding to accept an explanation from a client that a failure in a key control was a "once-off" due to some particular circumstance and did not recur regularly during the year without properly testing the explanation by, for example, performing more extensive tests of controls. Such a decision could lead to an inappropriate assessment of control risk which would, of course, have a knock-on effect for the assessment of detection risk and ultimately audit risk.

One of the possible sources of familiarity arises from having contact with the client over too long a period of time. This is particularly a problem for higher level members of the audit team. In practice, it is also more likely to occur with higher level members of the audit team because at the level of Audit Senior and below staff turnover is likely in most firms to be sufficient to ensure that staff move on over a relatively short period of time.

Ensuring that this happens with more senior members of the audit team raises the question of creating regulations, or at least recommendations, about Audit Rotation. Obviously, the most extreme form of Audit Rotation would be to require audit firms to be rotated after a certain number of years. A second, less draconian, possibility is to require the Audit Partner (and/or other senior staff) to rotate periodically though leaving the firm in place.

Ewelt-Knauer et al (2012), in a paper commissioned by the Institute of Chartered Accountants in Scotland (ICAS), examine the situation as regards the rules, regulations, and guidance internationally and made the following observations about the situation:-

• *Several countries (for example, Brazil, India and Italy) have introduced mandatory rotation in the past. By contrast other countries have abolished formerly issued regulations on audit firm rotation (for example, Spain and Canada).*

• *Australia is currently debating a pilot program to obtain sufficient empirical data to arrive at a satisfactory conclusion.*

• *India requires a compulsory rotation of the audit partner and 50% of the audit team.*

• *Portugal recommends an eight to nine-year rotation on a 'comply or explain' basis for listed companies.*

• Slovenia gives public companies a choice to either conduct a five-year partner or firm rotation.

• In Bosnia Herzegovina rotation is required after five years, although mandatory firm rotation can be postponed for two years if a new engagement partner is appointed.

• In Belgium, an auditor is appointed for a term of three years and cannot be dismissed within this period. The mandate can be renewed after three years.

Regulators in the UK, the US, and Germany have discussed the topic in the past, but conclude that the potential benefits of mandatory [audit firm] rotation do not outweigh the risks and costs.

However, for listed companies, the UK, Germany and the Netherlands, and indeed Ireland mandate audit partner rotation instead of firm rotation. In the UK and Ireland APB's Ethical Standard 3 (Revised) *Long Association with an Audit Engagement* (paragraph 12) requires the audit partner to rotate after 5 years and not return to the audit for 5 years.

There have also been suggestions in the UK that listed companies should be required if not to rotate their auditors periodically at least to put the audit out to tender. In 2013, the UK Competition Commission proposed that list companies be obliged to put their audits out to tender at least every 5 years, but that suggestion did not find favour with, among others, the Financial Reporting Council (FRC). (Amofah, 2013)

There is, of course, a different argument that could be made in this respect. This argument would suggest that a long and close association between an audit firm/partner would enhance the auditor's (or the audit firm's) understanding of the client's business and thus make it more likely that any material misstatements in the financial statements would be discovered by the auditor. This, in turn would reduce detection risk and ultimately audit risk. For example Arel et al (2005) cited in Porter et al (2013) state that

[A] client must feel comfortable with an auditor and be willing to share information and discuss problems when they exist….An auditor must be able to gauge when the client is not revealing all available information and this often comes from knowing the client and its management. …The familiarity the auditor has with [a client] provides a better understanding of the issues and a better appreciation of the changes that have taken place from one year to the next. (p.37)

Frankly, although copious academic papers on the topic have been written over the years the results are largely inconclusive. Ewert-Knaurt et al (2012) conclude their summary of the research referred to above on the matter as follows:

Finally, while experimental, survey-based and analytical research largely confirms positive effects of rotation on 'independence in appearance', most archival research fails to extend such findings to various measures of audit quality associated with 'independence in fact'. Rather, most of the archival research suggests potentially adverse effects of rotation, at least for the first years after a switch. Meanwhile, some research suggests that excessive tenure can in some cases lead to reduction in audit quality, suggesting potential for rotation to alleviate tenure-related problems.

Concluding, taken as a whole, research results on the effects of mandatory audit firm rotation on auditor independence and audit quality suggest that while rotation might improve auditor independence, especially in appearance, one should not ignore the negative consequences rotation might have for the client-specific expertise of the auditor. Given the lack of evidence linking mandatory rotation with an improvement in audit quality, regulators need to carefully determine the long-term objectives of a mandatory rotation.

There are also, of course, other factors to be considered, especially when it comes to audit firm rotation. Rotation is costly both for the client and for the audit firm. Rotation could lead to audit firms being more reluctant to invest in, for example, sophisticated specialised audit software if they know with certainty that the client will be rotated to another firm in a few years. In the case of large clients the market is now so concentrated that they may have few places to go. This is especially the case for multi-national firms whose reach and extent means that they need a "Big 4" firm to do the audit and possibly a different one if they come within the requirements of the Sarbanes-Oxley Act 2002 (SOX) for companies listed in the US. Others (for example, Arrunada and Paz-Ares (1995)) argue that mandatory audit firm rotation would lead inevitably to a de-concentration of the market because so-called "second-tier" firms would be required to step up to undertake some of these assignments.

A slightly different argument against mandatory rotation is raised by PricewaterhouseCoopers (2002) and SDA Università Bocconi (2002), cited by Porter et al (2013). This argument is that audit rotation (at either firm or, to a lesser extent, partner) level is unnecessary because there are more effective and less costly ways to ensure audit quality. These include

- *(i)* *Independent quality control reviews of audit firms' and audit teams' members' independence.*
- *(ii)* *Audit firms' quality controls and governance mechanisms.*
- *(iii)* *Effective oversight (or inspections) of auditors' performance and independence by regulatory bodies.*

These arguments lead to the conclusion that perhaps audit firm rotation does not necessarily lead to better outcomes. The *Parlamet** scandal in Italy occurred at a time when audit firm rotation was in place there. However, audit partner rotation is less costly (especially for the client) and is perhaps an acceptable compromise which leads at least to the enhanced appearance of independence and is not too onerous especially if confined to larger public interest-type clients.

**This refers to the collapse of a giant Italian food group in 2004 amid following instances of accounting falsifications and the alleged deception of the auditors.*

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