Fédération des
Experts Comptables
Européens

FEE Study
Mandatory Rotation of Audit Firms

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The periodic rotation of a company's audit firm is raised from time to time as a possible way of ensuring that audit independence is maintained. The proposed EU Eighth Directive on Statutory Audit, if adopted in its initial draft form, would establish a special regime for public interest entities, including the option for member states to require audit firms to rotate within a maximum period of seven years as an alternative to audit partner rotation within five years (Article 40).

In its letter of 2 June 2004 to the European Commission FEE recommended that the proposed Directive be amended to omit the suggestion that rotation of audit firms should be seen as an alternative to rotation of partners.

FEE has undertaken a study of the arguments and conclusions reached by governments, regulators, academics and professional bodies who have considered external rotation of audit firms. The findings of this study are presented in this report.

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EXECUTIVE SUMMARY

In this paper FEE analyses a number of studies addressing the impact of mandatory rotation of audit firms on audit quality and on auditors' independence. Almost all of the studies conclude that the detrimental effects of firm rotation on the quality of the audit work by far outweigh its positive effects as a safeguard against various independence threats.

Credible financial information is a necessity in a free market. One important tool for securing credibility in the financial reporting chain is statutory auditing. High quality auditing requires that the auditor is objective and competent. A long-term relationship between an auditor and their audit client creates a risk of excessive familiarity that might impair objectivity and independence. Mandatory rotation of audit firms appeals to some commentators in that it would not allow such long-term relationships to develop.

FEE has reviewed the most important studies on this subject, almost all of which recognise that there are serious disadvantages in mandatory rotation of audit firms. An audit requires a depth of understanding of the business that cannot be built up in a short time. Studies have concluded that discarding the audit firm's cumulative understanding every five or seven years will inevitably lead to a higher risk of audit failure in the early stages of a new appointment. Mandatory firm rotation also has implications for the free choice for those charged with governance to choose their company's auditors, for competition in the audit market and for the long-term health of the auditing profession.

The perceived audit quality benefits of firm rotation are achieved in many countries through alternative means, including rotation of the audit partner every five or seven years, appointment of independent review partners, internal quality control procedures and external oversight of the work of audit firms. Many regulators have concluded that these steps are sufficient to mitigate the risk of excessive familiarity and to assure auditors' objectivity. These steps are also incorporated in the proposals of the EU Eighth Directive on Statutory Audit or in the quality control arrangements laid down by the International Audit and Assurance Standards Board which are to be adopted in the EU under the proposed Directive.

These safeguards are already provided for in proposed audit regulation throughout the EU. FEE's study has identified very few incremental benefits to be gained by supplementing these safeguards with mandatory rotation of audit firms. Conversely, mandatory rotation would introduce all of the disadvantages for audit quality identified by the studies FEE has reviewed.

The overwhelming majority of the studies FEE has reviewed conclude that it would harm the quality of auditing to supplement the reforms currently proposed in the EU with an additional requirement for mandatory rotation of audit firms.

FEE urges all those who wish to understand this topic to recognise that the superficial attraction of mandatory firm rotation should be compared with the very tangible threats to audit quality. These, in turn, threaten the programme to build public trust in financial reporting.

I. INTRODUCTION

Background

Credible financial information is a necessity in a free market. Consequently, it is an essential condition for the establishment of an internal market in the European Union. One important tool for securing credibility in the financial reporting chain is statutory auditing.

A number of recent financial reporting failures, notably in the United States but also in Europe, have raised concern over the credibility of annual reports. Questions have been asked about the quality of the statutory auditors' work. Audit quality depends on auditors' *competence* and their *objectivity*. *Competence* is derived from professional training, general experience and understanding of each particular client and industry. The educational requirements have been regulated for decades in Community legislation, and technical standards were developed by the profession even earlier.

Audit quality also depends on auditors' *objectivity*. While this is primarily a state of mind, it can be affected by auditors' independence which supports the absence of improper external influences. The profession adopted Codes of Ethics covering auditors' independence many years ago, but it is only recently that EU legislators have taken an active interest in this topic. An important step was taken with the Recommendation on "Statutory Auditors' Independence in the EU" in May 2002. The conceptual framework approach of that Recommendation has also been adopted by the International Federation of Accountants (IFAC) in its Code of Ethics and by IOSCO in its Principles of Auditor Independence.

In the wake of the scandals, legislators and regulators have questioned whether the conceptual framework approach needs to be supplemented by explicit rules in key areas. The subject of this report – the term of an audit firm's appointment (mandatory rotation) – is one of the areas that have been considered.

FEE's Review

In recent years a number of studies into mandatory rotation of audit firms have been undertaken by governments, regulators, academics and professional bodies. FEE has prepared this report in order that the main arguments considered in these studies can be presented in a single document.

We have aimed to present the results in an impartial and neutral way, summarising both advantages and disadvantages. The consensus from the studies is that mandatory firm rotation has serious disadvantages that outweigh its perceived benefits. If this report emphasises the disadvantages of mandatory rotation, that should be seen as a reflection of this consensus rather than a bias in preparation of our report.

The studies we have reviewed are listed in the Appendix. All of these reports are available publicly and we have indicated how copies can be obtained. We searched for relevant publications using available bibliographies and the Internet. We have focused on those studies which were based on empirical research or expert review, and have therefore excluded the many comments and opinions on this topic expressed through the media.

In Section I we have considered the studies' conclusions relating to audit quality and in Section II the additional comments made in relation to the market impact. Due to their nature the studies are necessarily abstract and refer only briefly to the root causes of some of the issues identified. In Section III we have considered how frequent changes of audit firm, whether resulting from mandatory rotation or otherwise, introduce threats to independence and operational difficulties that make audit failure more likely. Section III has been prepared by practitioners based on their experience and is therefore necessarily more subjective than the sections derived from impartial, third party studies.

FEE is an organisation whose member bodies largely represent audit practitioners. Some may therefore perceive that FEE has a conflict of interests on the topic of mandatory audit firm rotation. However, our concern is not the wish to preserve the client bases of audit firms - that is something some audit firms may want to achieve while others may welcome more market volatility. Instead, our concern is that FEE regards mandatory firm rotation as an unnecessary step whose main impact will be to increase the risk of audit failure. This is not in the public interest and will damage the reputation of the auditing profession and its ability to attract talent for the future. At a time when the restoration of public trust in financial reporting is a key priority, such changes should be avoided.

Reports and Legislation we have reviewed

The reports we have reviewed are summarised by reference to their historical context. Mandatory firm rotation has been raised as a potential change in a number of countries:

- In the USA, the government's General Accounting Office ("GAO") was required by the Sarbanes-Oxley Act of 2002 to consider whether mandatory firm rotation would be beneficial. They reported in November 2003 that, considering the costs and benefits of mandatory audit firm rotation and the recent reforms already being implemented, several years' experience will be needed to evaluate the effects of the Act. GAO concluded that the most prudent course of action at this time is for the Securities and Exchange Commission and the Public Company Accounting Oversight Board to monitor the effectiveness of the Sarbanes-Oxley Act's requirements for enhancing auditor independence and audit quality. In 1992, the SEC Practice Section of the American Institute of Certified Public Accountants ("AICPA") compiled a report that concluded that mandatory audit firm rotation would not enhance audit quality or strengthen investor confidence in the objectivity of audits - already protected by numerous safeguards.

- In the UK, the Government established a "Coordinating Group on Audit and Accountancy" ("CGAA") to consider a range of reforms in response to the loss of public trust following the Enron and other scandals in the USA. The CGAA reported in January 2003 and recommended that the frequency of rotation for the lead audit partner should be increased to every 5 years, but that rotation of firms was not a necessary step. In 2002, the Institute of Chartered Accountants of England and Wales ("ICAEW") had issued its review of current requirements, research and publication on mandatory rotation of audit firms.

- In 1998, the proposals to reform French Company Law included a provision to limit the term of the statutory auditor to six years. This proposal was introduced based on the sole argument that it would increase the independence of the statutory auditors. A working group on the independence and the objectivity of the statutory auditors concluded that the independence of statutory auditors can be assured by other measures. The provision was dropped from the reform proposals.

- In Italy, where mandatory rotation of firms has been a requirement since 1974, a study by the Bocconi University ("Bocconi") in Milan in 2002, has identified a number of disadvantages from firm rotation. However the Galgano Committee, formed in response to the scandals in the USA, concluded that mandatory rotation should continue. The Galgano report ("Galgano") does not set out the basis for its conclusions nor why the earlier report has been disregarded. (It should be noted that Italy has not so far instituted external inspection of auditors of the type described in the European Commission Recommendation on quality assurance of November 2000 and widely in force elsewhere. Mandatory rotation of firms may therefore have been considered, to some degree at least, an alternative safeguard.) The Eighth Directive on Statutory Audit will make external inspection a requirement for the first time.

- In Spain, the Statutory Audit Law of 1988 introduced mandatory rotation after a maximum period of nine years with a prohibition to take up the same audit engagement before at least a three-year period has elapsed. The Limited Liability Partnership Act of 1995 removed such prohibition and in fact abolished the mandatory rotation requirement. Subsequently, the Spanish Government funded the Arruñada and Paz-Ares ("Arruñada and Paz-Ares") report which supported this decision.

- In Austria, mandatory rotation of audit firms after six years of service was due to become effective on 1 January 2004. This requirement has been put on hold for two years and a final decision has been made dependent upon finalisation of European legislation on the statutory audit. Similarly, mandatory rotation of audit partners has also been put on hold.

- In 1999, the Irish Parliament's Public Accounts Committee made a number of recommendations, including the possible introduction of mandatory rotation of auditors of financial institutions. The Department of Enterprise, Trade & Employment established a Review Group on Auditing to examine and report on these recommendations ("Review Group on Auditing"). In 2000, the Review Group advised against rotation and this was subsequently accepted by the Irish Government.

- In the Czech Republic, mandatory auditor rotation limiting the audit mandate to four consecutive years became effective in July 1989 following a decree on auditors of the Ministry of Finance. It was abolished in November 1992 and the issue has dropped from the agenda.

- In the Slovak Republic, mandatory audit firm and statutory auditor rotation was introduced by the Auditing Law in October 1996 for all audits. The maximum duration of an audit mandate was three years with a cooling-off period of five years. This provision was removed mid 2000. The most influential argument was the drive to harmonise Slovak legislation with that in the rest of the European Union, where mandatory rotation applies only in Italy.

- In Latvia, a two-year audit firm rotation was required for banks. This rotation law was repealed in September 2001 following complaints from two of the country's largest banks that they were unable to find an international accounting firm prepared to undertake the audit.

- In the EU countries not mentioned above, the issue has been considered in varying degrees of depth in response to the scandals in the USA and elsewhere. None of these countries have introduced mandatory firm rotation.

II. THE CASE FOR MANDATORY FIRM ROTATION

Conceptual Background

Independence issues are generally analysed using a conceptual framework, sometimes referred to as the "threats and safeguards approach". This approach is used in the EU Recommendation on Auditors' Independence and has been adopted in Section 8 of the Code of Ethics of the International Federation of Accountants (IFAC) and by IOSCO in its Principles of Auditor Independence. This approach includes a scheme for analysing threats to auditors' objectivity and for using safeguards to eliminate the threats or reduce them to an acceptable level. If other safeguards are not sufficient, the auditor must abstain from the audit assignment or from the activity causing the threat. Threats under this scheme are called the self-interest threat, the self-review threat, the advocacy threat, the familiarity or trust threat, and the intimidation threat.

According to a current FEE study on the EC Recommendation and the IFAC Code of Ethics, "Senior Personnel Acting for a Long Period of Time" causes a perceived *familiarity or trust* threat to the independence of the auditor. The nature of this threat is that the auditor may be perceived as too trusting because of familiarity, thus resulting in insufficient professional scepticism or testing of representations made. In evaluating the significance of the threat a large number of factors should be considered, such as the length of time an individual has served, the role of the individual, the size and structure of the firm, and the nature of the engagement. The evaluation may also depend on whether the client is a public interest entity or not.

The available safeguards include: periodic replacement of key personnel, external quality review, seeking the advice of a professional regulatory body, or using a professional accountant, who is not a member of the engagement team, to review the work.

Arguments

As will be demonstrated in Section IV. "Achieving the benefits of rotation by other means" below, a framework of safeguards are already in place or being proposed. However, some commentators do not accept them as sufficient and have proposed that the framework is amended by introducing mandatory firm rotation as an alternative to partner rotation.

While such arguments have not normally been explicitly structured in accordance with the conceptual approach, they can often be easily related to the threats defined there. Thus the most frequent arguments have aimed at the avoidance of over-familiarity between auditor and client. Sometimes the self-interest threat is mentioned, in the form of the potential for influence on audit judgements arising from the desire to retain the client.

The arguments can be summarised as follows:

Familiarity Threat

GAO and CGAA explain in more detail the threat of excessive familiarity:

> *"The concern is whether the independence of a public accounting firm auditing a company's financial statements is adversely affected by a firm's long-term relationship with the client and the desire to retain the client."*
>
> *(GAO 2003)*

> *"The argument for firm rotation is that in a long term audit relationship, the auditors will tend to identify too closely with management, their proper professional scepticism will be diluted and they will be more likely to smooth over areas of difficulty in order to preserve the relationship and in particular the long term income which flows from it."*
>
> *(CGAA)*

Perception of Audit Independence

Galgano and Bocconi focus on the way mandatory rotation supports the perception of audit independence:

> *"The Galgano Committee recommends for the safeguard of auditor's independence that the audit engagement cannot be immediately renewed (there is a possibility of renewal only after six years have elapsed after the end of the engagement). The exclusion of an immediate renewal of the engagement avoids any influence on the judgment of the auditors driven by a hope for renewal."*
>
> *(Galgano)*

> *"Increase in perceived independence: the results of the empirical research performed indicates that many respondents (internal auditors, managers of Italian listed companies, financial analysts, members of the "Collegio Sindacale" of listed companies and listed banks, Big 5 audit firm partners and Big 5 audit firm controllers) believed that the current mandatory audit rotation rule in Italy constitutes a potential mechanism to improve audit independence."*
>
> *(Bocconi)*

"Fresh Look"

Others have also cited the benefit of a "fresh look" at a company's accounting which will take place each time a new auditor is appointed:

> *"They (those who support mandatory audit firm rotation) believe that periodically having a new auditor will bring a "fresh look" to the public company's financial reporting and help the auditor appropriately deal with financial reporting issues since the auditor's tenure would be limited under mandatory audit firm rotation."*
>
> *(GAO 2003)*

> *"The prolonged continuity of an auditor with a client can, however, lead to audit work becoming excessively routine, which would ultimately affect his competence. A long period working with the same client can lead the auditor to put too much trust in the previous years' work and, consequently, may lead him to treat the work as a repetition of the reviews performed in prior years. It is argued that this creates a tendency to anticipate results instead of being alert to subtle and often surreptitious, though important, anomalies. A similar effect is alleged in terms of "self-revision" cases, those in which the auditor must report negatively on his previous work. In these contexts, by bringing a "fresh view" and forcing an in-depth review, rotation might attenuate these problems."*
>
> *(Arruñada and Paz-Ares)*

Rigour of the Audit Process

ICAEW also considers the following issues:

> *"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 & Moscove, 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).*

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."

(ICAEW)

Other Arguments

The research the ICAEW carried out shows the following arguments for mandatory rotation:

"The perceived benefits of mandatory rotation can be summarized 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."

(ICAEW)

In a desire to bring more focus to peer-review of auditing, the European Parliament expressed its wish to see mandatory firm rotation as an option:

"[The European Parliament] insists that the Commission speed up work on Directive 84/253/EEC on approval of persons responsible for carrying out statutory audits, and in this connection asks that the Commission prepare legislation to force companies to rotate their audit firm or switch the audit partner in charge of their accounts. [The European Parliament] dismisses the argument that this will risk damaging continuity and bring about more audit failures."

III. The Potential Impact on Audit Quality of Mandatory Firm Rotation

Introduction

The studies identify a number of disadvantages of mandatory firm rotation, of which the most frequently mentioned is the impact on audit quality:

> *"We argue that the rotation rule is not justified by its effects on audit quality because it probably damages the two main determinants of quality. The auditor's technical competence - i.e. his ability to detect irregularities in the financial statements - is hampered by the greater number of initial audits and the lesser degree of specialization."*
>
> *(Arruñada and Paz-Ares)*

The threat to audit quality that occurs in initial audits is most strongly demonstrated in Bocconi's research study:

> *"A possible measurement of the quality of audit services is constituted by the number of suspensions of partners imposed by the Consob (the Italian national commission for the 20 [audit firms of] listed companies). Generally in fact, cases of suspension arise in situations in which material misstatements were not pinpointed by auditors. The number of partner suspensions in Italy, imposed during the period between 1992-2001 amounted to 40. The analysis of the distribution of suspensions shows how they are mainly concentrated in the first year of an appointment with a total number of 13. The number of suspensions imposed over the following years drops dramatically, from one to three a year."*
>
> *(Bocconi)*

The Bocconi Report on Italy's experience of mandatory rotation found that there was a need for a "training period" of two to three years for new auditors of complex groups:

> *"By analysing the relationship between audit opinions and the duration of an audit appointment, it is possible to see that the highest frequency of qualified opinions, amounting to six, occurs during the third year of an appointment, when it is presumed that the audit firm has acquired deep knowledge on the auditee. The number of qualified opinions expressed during the other years of a nine year appointment is on average two and ranging from one to four."*
>
> *(Bocconi)*

> *"On the basis of the results of the research work carried out, the impact of the mandatory rotation rule on the quality of audit activities in Italy is:*
>
> - *Concentration of partner suspension during the first year of appointment;*
> - *Concentration of qualified opinions during the third year of appointment; and*
> - *Reduction in knowledge of client operations."*
>
> *(Bocconi)*

Loss of Cumulative Knowledge

The loss of cumulative client knowledge above is examined in more detail by CGAA and by Bocconi:

> *"There may be negative effects on audit quality and effectiveness in the first years following a change. Most obviously the cumulative knowledge of the existing audit team is lost and the new auditors need to go up the learning curve. The increasing complexity of large groups, and the complexities surrounding the financial reporting of their activities suggest that it can take the new auditors several years to fully understand the business."*
>
> *(CGAA)*

> *"a reduction in some key quality measures following mandatory rotation. In fact far from increasing the effectiveness of the audit, severing long term relationships between auditors and clients in an increasingly complex business environment could lead directly to a long-term diminution in the quality of auditing, with serious implications for investors and the financial system."*
>
> *(Bocconi)*

Difficulty Maintaining Industry Specialisation

A second impact on audit quality arises from the difficulties audit firms would experience in developing and maintaining the industry knowledge necessary to operate in many specialised sectors and in all the necessary locations worldwide, some of which may comprise only a handful of potential audit clients.

> *"It seems that the introduction of mandatory rotation can seriously impair auditor specialization. In a static perspective, it does not allow pre-existing economies of scale to be exploited. From a dynamic perspective, given that it substantially reduces the incentive to invest in specialized resources, the rule will lessen the future degree of specialization and with it the level of auditor competence."*
>
> *(Arruñada and Paz-Ares)*

> *"… it would be difficult for companies operating in very specialized industries to meet mandatory rotation requirements thus potentially impeding audit quality. In some industries, major audit firms may possess differing levels of expertise to effectively serve a particular company. If one of those firms provides internal audit services and another provides prohibited non-audit services, the only way for the company to meet the rotation requirement would be to choose a firm that lacks the depth of industry expertise, which could increase risks and potentially harm the company as well as its shareholders."*
>
> *(GAO 2004)*

Cost

The studies quoted above indicate that mandatory firm rotation can have a negative impact on audit quality through the loss of cumulative knowledge and the difficulty in maintaining industry specialisation. Those favouring rotation may suggest that these difficulties can be overcome by additional procedures to develop the new auditor's knowledge more quickly. However, we explain in Section III why we believe this is not simply a matter of resource allocation. A new audit appointment introduces increased risks which require safeguards from both auditors and those charged with governance. Mandatory rotation puts more pressure on those safeguards and, as noted in several studies, the additional costs and company management time should not be underestimated:

> *The potential benefits of mandatory audit firm rotation are harder to predict and quantify, though GAO is fairly certain that there will be additional costs"*
>
> *(GAO 2003)*

> *"costs were 15% greater for a new client in a familiar industry and 25% higher in a new client in a new industry. Further, in the first year of an audit, Bocconi reported that 40% more audit hours were invested to familiarise with the business, processes and people."*
>
> *(Bocconi)*

> *"mandatory rotation makes audits more costly because it increases production costs and reduces competition in the marketplace. The increase in costs derives from the fact that a substantial amount of specific assets - connected most visibly, but neither only nor fundamentally, to initial audits - is destroyed and must to a large extent be rebuilt in each rotation."*
>
> *(Arruñada and Paz-Ares)*

> *"There are substantial costs resulting from a requirement to switch auditors regularly. Most obviously, the new auditor has to become familiar with the company's business and its financial and non-financial procedures, systems and recent history. However, there are also significant costs in terms of management time particularly in terms of working with the new auditors to familiarise them with the company"*
>
> *(CGAA)*

While cost should not be a decisive argument when set against audit quality, the consensus view is that the quality benefit is doubtful while the costs are very tangible. We consider in Section V the impact of mandatory rotation on competition in the audit market and note Bocconi's conclusion that it has generally led to a reduction in audit fees. Any change that worsens the economics of audit firms while increasing the risk of audit failure is not in the best interests of a robust and sustainable auditing profession or of the business community as a whole.

Audit Quality Impact - Conclusions

Each of the studies compares the perceived benefits of mandatory firm rotation against the potential risks. The consensus view is that rotation is not the best way to achieve the desired safeguarding of audit independence:

"It should be noted that the researchers believe that it (rotation) risks being simply a "theoretical" solution to the problem of independence which in practice carries significant risks."

(Bocconi)

"GAO believes that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional financial costs and the loss of institutional knowledge of the public company's previous auditor of record, as well as the current reforms being implemented following the Sarbanes-Oxley Act."

(GAO 2003)

"There is no strong evidence from Italy (which requires audit firm rotation every nine years for the 20 [audit firms of] listed companies) or Spain (which abandoned a similar requirement for listed companies in 1995) of a positive impact on audit quality. Research in Italy concludes that rotation carries significant threats to audit quality from competitive pressures and that other approaches focusing on audit partner rotation, quality control in firms and effective regulatory oversight might be preferable."

(CGAA)

"Overall, the Review Group considered that the introduction of mandatory auditor rotation could undermine the effectiveness of audits."

(Review Group on Auditing)

"We do not believe it appropriate to mandate rotation of audit firms. The Audit Review Working Party, in also reaching this conclusion, stated that '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'. We agree with these comments."

(Ramsay on "Independence of Australian Company Auditors")

These conclusions show the difficult choice between the understandable desire to avoid personal relations between auditors and clients, and the detrimental effects of rotation on an auditor's awareness of the client's business, risks and industry.

IV. ACHIEVING THE BENEFITS OF ROTATION BY OTHER MEANS

Necessary Safeguards

In examining the impact of mandatory firm rotation on audit quality and independence, a number of the studies identify existing safeguards which reduce the need for such a radical and disruptive solution:

> *"In identifying possible solutions to perceived independence problems, it should not be forgotten that the need for independence refers basically to the responsible engagement partner, and so it is necessary to identify the control mechanisms that focus the most on single partners rather than on audit firms. In view of this it could be an idea to concentrate on the following mechanisms*:
>
> - *Rotation of engagement partners within the audit firm;*
> - *The role of the second partner and of internal control and governance mechanisms in audit firms;*
> - *Peer review among auditors in the firm, between audit firms and by professional bodies; and*
> - *Supervision by regulators."*
>
> *(Bocconi)*

> *"In our view there are in any event sensible and effective alternatives to audit firm rotation. These alternatives form key elements of our conclusions - the enhanced role for the audit committee in relation to the appointment and oversight of the company-auditor relationship; the requirements for audit partner rotation; the greater transparency by the major audit firms on how they maintain audit quality and auditor independence; and the greater emphasis on independence when monitoring long-standing auditors. We do not therefore recommend mandatory audit firm rotation."*
>
> *(CGAA)*

GAO and CGAA also identified the safeguard provided by empowering the audit committee of public interest entities to select, supervise and scrutinize the audit firm and their independence.

> *"In that respect, we reported that audit committees, …, can play a very important role in enhancing auditor independence and audit quality. For example, if audit committees regularly evaluate whether audit firm rotation would be beneficial, given the facts and circumstances of their companies' situation, and are actively involved in helping to ensure auditor independence and audit quality, many of the intended benefits of audit firm rotation could be realized at the initiative of the audit committee rather than through a mandatory requirement."*
>
> *(GAO 2004)*

> *"We strongly endorse the proposal from the Financial Reporting Council Group chaired by Sir Robert Smith that the Audit Committee should make recommendations to the Board (and thus to the shareholders who formally appoint the auditors) on the appointment of the external auditor and approve the remuneration and terms of engagement of the external auditor."*
>
> *(CGAA)*

Safeguards in the Proposed Eighth Directive on Statutory Audit

The safeguards identified above are in force, or are proposed to be introduced, throughout the European Union. In the proposed Eighth Directive on Statutory Audit:

- Article 40(c) introduces a requirement for the key audit partner to rotate every five years.

- Article 38 will require firms engaged in audits of public interest entities to publish an annual "transparency report" including a description of their internal quality control system.

- Article 26 proposes the adoption by the European Commission of International Standards on Auditing. The recent amendments to ISA 220 "Quality control for audit work" include requirements, among others, for review of audit work and conclusions by an independent review partner.

- Article 29 will require member states to ensure that all statutory auditors and firms are subject to a system of quality assurance meeting specified criteria for rigour and independence. (Other requirements for quality control are set out in Article 15 (3) on the public register showing the competent authorities in charge of quality assurance, Article 33 (2) and (3) on the mutual recognition of regulatory arrangements between Member States, Article 40 (d) on the cooling-off period before a key audit partner can accept a management position in a client and in Article 41 on the frequency of quality review).

- Article 31 will require member states to introduce a system of public oversight for statutory auditors and firms meeting specified criteria. (Further requirements on public oversight are set out in Article 15 (3) on the public register showing the competent authorities in charge of public oversight, Article 29 (1) (a) on the independence of the quality assurance system and its public oversight, Article 31 (4) (b) and (c) on the ultimate responsibilities of the public oversight system and in Article 32 on cooperation between public oversight systems at Community level).

- Article 39 will require public interest entities to have audit committees. Their responsibilities will include monitoring the independence of the statutory auditor or firm.

- Article 43 will require the board's proposal for the appointment of a statutory auditor or firm to be based on a selection made by the audit committee.

This list of reforms, backed by appropriate oversight arrangements to ensure effective implementation, provides each of the safeguards envisaged by the Bocconi and other studies.

Summary

When these reforms are in place throughout the EU, we must consider what incremental benefit is to be gained by replacing the partner rotation requirement by mandatory firm rotation. It is difficult not to conclude, based on this review of the published studies that such a change would add little incremental benefit for audit independence but that the disadvantages for audit quality would all be realised. On this basis, such a change would not be in the public interest.

V. THE POTENTIAL IMPACT OF MANDATORY FIRM ROTATION ON THE MARKET FOR AUDIT SERVICES

Introduction

One argument put forward for mandatory firm rotation is that it increases volatility in the audit market and so stimulates competition. This may be seen as an encouragement to smaller firms to grow and challenge the "Big 4". However, the studies indicate that mandatory external rotation of audit firms actually results in decreased competition in the audit market:

"…one of the goals of those who defended rotation rules in the past was to favour competition, on the grounds that mandatory rotation would in the long term dilute audit firm concentration. This reasoning does not hold water, however, and it is countered by significant theoretical and empirical arguments."

(Arruñada and Paz-Ares)

Arruñada and Paz-Ares identify in particular the risk of collusion among audit firms, together with the effect of short-term appointments on the willingness of firms to invest and compete:

"The (mandatory rotation) rule also drastically alters the pattern of competition in the auditing industry. It directly creates a system of turns and, in short, an artificial division of the market, which can favor collusion among auditing firms. More importantly, it also reduces the incentive to invest and compete because firms that manage to excel under it find themselves obliged to relinquish their achievements periodically."

(Arruñada and Paz-Ares)

Bocconi records similar themes:

"Competition in the audit market:
- *Market shares become stable with concentration of audits in Big 5 firm*
- *Decrease in the number of auditors competing for a new appointment*
- *Potential for collusion among audit firms"*

(Bocconi)

Price Competition

GAO notes that:

"However, competition among public accounting firms for providing audit services should to some extent also affect audit fees. If intensive price competition were to occur, the expected benefits of mandatory audit firm rotation could be adversely affected if audit quality suffers due to audit fees that do not support an appropriate level of audit work."

(GAO 2003)

Bocconi echoes this concern:

"The current rule of mandatory external rotation seems to have intensified price competition in Italy. In the case of auditing which is generally considered as a "public interest" activity, this could be considered as inappropriate. This is even more so if growth in competitive pressure in the audit market exceeds the ability of the governance and management ethics culture to cope."

(Bocconi)

Concentration of Audits in Big Audit Firms

A considerable number of studies identified that mandatory firm rotation, as a result of decreased competition in the audit market, would increase rather than dilute concentration of audits in a small number of big audit firms to the detriment of other firms:

"Public interest is especially strong in the audit of listed companies and major public interest entities. At the same time, special skills (always) and extensive resources (frequently) are needed in the audit of such companies. This has led to the concentration of the audit of listed companies in the hands of a small number of firms (the Big Four firms carry out 76% of listed company audits)."

(CGAA)

"Regarding competition-related effects of mandatory audit firm rotation, 54 percent of Tier 1 firms believe mandatory audit firm rotation would decrease the number of firms willing and able to compete for audits of public companies and 83 percent of Tier 1 firms believe that the market share of public company audits would either become more concentrated in a small number of public accounting firms or would remain the same."

(GAO 2003)

In choosing auditors, large multi-national groups will assess geographical spread, size, capabilities and the depth of specialist skills in each location. Smaller firms' ability to compete in this sector will be affected by restrictions on the proportion of a firm's total revenues they can earn from any one client, and they may be reluctant to take on the uninsured risk in environments where liability is unlimited. A multi-national group which is forced to rotate away from a particular small firm which held the audit appointment for historical reasons may be reluctant to change to another firm of similar size when the capital markets expect a larger firm to be appointed:

"Most public companies will only use the Big 4 firms for their auditor of record for a variety of reasons, including the firms' having sufficient industry knowledge and resources to audit their companies and expectation of the capital market to use Big 4 firms."

(GAO 2003)

"We previously reported that smaller public accounting firms were unable to successfully compete for the audits of large national and multinational public companies because of factors such as lack of capacity and capital limitations."

(GAO 2003)

GAO also identified the practical impact of the need for specialist and industry knowledge:

> *"Advantages of concentration in an industry would become greater for the 4 largest firms, to the detriment of the other firms."*
>
> *(GAO 2004)*

The specialisation and industry expertise, which is required to be able to perform an audit engagement, might not be available at all international locations of another audit firm where the audit client is located (for instance expertise in the area of financial services):

> *"The individuals we spoke to, however, acknowledged a number of practical concerns related to mandatory audit firm rotation, one of the most important being the limited number of audit firms available from which to choose. For example, some companies, especially those with geographically diverse operations or those operating in certain industries, may be somewhat limited in the choice of auditing firms capable of performing the audit. Not all audit firms have offices or staff located in all the geographic areas, whether domestically or internationally, where the clients conduct their operations, nor do all audit firms have personnel with certain industry knowledge to be able to perform audits of clients that operate in specific environments."*
>
> *(GAO 2003)*

Bocconi's research demonstrated that these considerations actually led to an increase in concentration in Italy:

> *"Market shares become stable with concentration of audits in Big 5 audit firms: on the basis of the results of the research work carried out, the impact of the mandatory rotation rule in Italy on competition in the audit market is higher concentration of audits in Big 5 audit firms which leads to a stabilization of the market share of Big 5 audit firms."*
>
> *(Bocconi)*

Restriction of Choice

For the reasons given above, many large multi-national companies will restrict their tender list for new audit appointments to a handful of the largest firms. CGAA foresees that the limited availability of audit services providers might distort the market in unexpected ways:

> *"If the existing concentration in the listed company audit market continues, it may prove difficult or even impossible in specific cases to identify an audit firm willing, able and not itself prevented by independence requirements to accept the engagement. Audit teams might simply switch audit firms to meet the rotation requirement"*.
>
> *(CGAA)*

This can have a detrimental affect on competition. For example, in the case of a company seeking a new "Big 4" auditor:

- In a mandatory rotation regime, one such firm will be the retiring auditor.

- Where the company uses another firm extensively for non-audit services, that firm and the company may be reluctant to disturb their relationship for the provision of professional non-audit services. With increasing restrictions on the level of non-audit services a firm can provide to an audit client, the commercial implications for the firm must be considered. They may be reluctant to surrender non-audit work, often under the protection of a contractual liability cap, for an audit engagement with unlimited liability.

- There are many industry sectors where conflicts between competing companies mean a rival's auditor will not be invited to tender.

In a world of four big firms, this would leave only a severely restricted choice and little competition for the appointment. Whether available firms have the necessary capability in every territory where the multi-national company needs them will be largely a matter of luck. This threat was identified in the CGAA and GAO reports.

CGAA identified the impact of such conflicts on competition:

> *"Increased concentration in an industry may have adverse implications for competition and choice. This is especially so in an industry where conflicts of interest might further limit client choice."*
>
> *(CGAA)*

GAO, which reviewed the US environment where many of the independence rules are expressed as simple prohibitions, went further in identifying independence requirements as preventing accounting firms that have provided non-audit services from taking on the audit engagement within a period of twelve months:

> *"Similar to the views of Fortune 1000 public companies and audit committee chairs, individuals we spoke to noted that large companies are often limited to choices among the Big 4 firms. In some cases, the choices are further restricted because the accounting profession has become segmented by industry, and a lack of industry-specific knowledge may preclude some firms from performing the audits. For a company that is limited to use of Big 4 firms, it was viewed that selection may also be restricted because an audit firm providing certain non-audit services or serving as a company's internal auditor is prohibited by independence rules from also serving as that company's auditor of record. In some cases, a company may also be limited in its choice of firms if an audit firm audits one of the company's major competitors and the public company decides not to use that firm as its auditor of record."*
>
> *(GAO 2003)*

Similar difficulties apply to other independence restrictions. Audit firms which are, or whose partners are, major customers of banks or pensions providers may choose not to compete for their audits in view of the cost of switching their arrangements.

As illustrated above, the combination of reduced scope of services for auditors, unlimited liability for audit work and mandatory rotation of firms would present a significant challenge to a competitive and efficient market for audit services.

VI. OPERATIONAL AND BEHAVIOURAL PROBLEMS IMPOSED BY MANDATORY FIRM ROTATION

Operational Difficulties and Threats to Objectivity

In this section we consider the operational and behavioural difficulties that we suggest mandatory firm rotation might stimulate. To our knowledge, there has been no comprehensive study of these issues. Therefore the statements below are based on the experience of audit practitioners in European member states in addressing the issues that arise on a change of auditor at a large public interest entity. Therefore, this section of the report is necessarily more subjective.

We have considered the operational difficulties and threats to objectivity that arise at each of the main stages in a fixed term audit appointment. We have also identified in general terms how audit firms put safeguards in place to manage these threats and to achieve successful transition in the majority of cases. We note, however, that if the threats were not introduced then the extra safeguards would not be necessary.

Before Appointment

In the period before appointment, it is likely a large client organisation will have tendered its audit competitively. Assuming the constraints identified in Section II do not in practice restrict choice, this means that firms will generally have been competing with others for the new appointment. They will have been working to please their potential client and to present their offerings in the best possible light. In some cases, particular accounting treatments may be tested out with the tendering firms to ensure that their appointment would not lead to accounting restatements. Firms usually ensure that any such advice is checked with a partner who has no interest in winning the engagement and that, in countries where they exist, the "opinion shopping" rules of their professional bodies are followed.

It is inevitable that fees will be a part of the tender process. Where the company uses competition to drive down the audit fee, firms will be looking for ways in which they can minimise their cost and re-engineer the audit creatively. There may be temptation to cut the audit work. This is of course unacceptable which is why audit firms have internal and external quality control procedures in place which will safeguard this risk by focusing on new audits. Also, in some countries, the audit regulators specifically review new audit appointments to ensure that, whatever economies have been found, they have not led to a failure to comply with auditing standards.

First Two Years of Appointment

On appointment, the auditor has to change approach from that of persuading a potential client of the merits of the audit firm to that of the independent and objective professional acting on behalf of the stakeholders to whom the report is addressed. This transition is not easy to make, but there are also further challenges:

- The auditor may not have developed a full understanding of the business. This requires both understanding of the industry and detailed knowledge of the client's activities. This process takes time, as the learning curve for the key decision makers in the audit team cannot be accelerated simply by allocating more resources. Without this knowledge, it is very difficult to identify unusual transactions whose purpose may not be fully apparent to the auditor or to assess audit risk effectively.

- When disagreements arise between management and auditor, they are most effectively dealt with in the context of an open, straight-talking relationship. This relationship also takes time to develop and it is understandably more difficult to deal with an area of disagreement in the early stages. There is the threat that, at worst, such disagreements can destroy a new relationship and lead to a change of auditor, or of audit partner, at the earliest opportunity. (Indeed many countries provide for audit appointments to run for three yearly terms to mitigate this risk.) It has to be acknowledged that there is pressure on the audit partner to avoid confrontations that put relationships with management at risk in the early stages of the term.

- In a client organisation of any size, it is often difficult for an audit partner to know who to speak to in order to ensure that audit recommendations are accepted and implemented. It is rarely sufficient for the auditor to present recommendations to those charged with governance without first testing them with the key company managers who will be responsible for implementation. It takes a considerable investment of time, on the part of both management and auditor, to build the understanding of the client structures (both formal and informal) needed for an effective audit.

- Teamwork between the members of the worldwide audit team of a multi-national company needs to be developed. This is not simply a matter of appointing partners in each location, but more a task of developing relationships so that there is a shared understanding of audit risks and open communication of audit conclusions and concerns. Formal inter-firm reports and reviews of working papers will only cover the tangible results of the audit work at subsidiaries. A deeper relationship is needed before those involved will be comfortable sharing tentative concerns which are often the first sign of something amiss.

It can be seen that a change of audit firm can make it both less likely that the auditor will identify potential errors and more likely that they will be inclined to accept unusual treatments rather than provoke a disagreement. The best companies and auditors will work together, with oversight from the Audit Committee or Supervisory Board, to overcome these challenges and achieve a successful audit transition. However, where a change is forced on the management through mandatory rotation, they may be less keen to provide the necessary induction programme for the new auditor. Moreover, an unscrupulous management who are deliberately misleading their auditors will find that regular change of auditor will reduce the chances of their schemes being discovered.

Last Two Years

In the final stages of a fixed term audit appointment, the majority of professional auditors will work diligently until the end of their term. However, other unacceptable effects cannot be ruled out. At one extreme, the auditor might simply lose interest, undertake the minimum work necessary but with an obvious threat to quality. At the other extreme, and particularly in circumstances where auditors are severely restricted in the range of non audit services they are allowed to deliver, it is possible that the retiring firm will have a target of winning a majority of the non audit work after their audit appointment comes to an end. In these circumstances, there is a clear threat to their objectivity.

Finally, it has been known for key members of the former audit team to join the newly appointed firm on a change of auditor. Consequently, mandatory audit firm rotation may neutralise the beneficial effects of mandatory partner rotation.

Practical Difficulties in an International Group

Allowing certain member states to implement mandatory firm rotation while others do not will also lead to practical difficulties in the audit of an international group.

In certain member states, the mandates of statutory auditors or audit firms are protected and are predetermined to last a number of years. This period varies from one member state to another. For a multi-national group of companies, mandatory rotation could very well result in switching audit firms in different member states in different years. This position would be exacerbated if, under the discretion given to member states to define a "Public Interest Entity" (Article 2 (11) of the proposed Eighth Directive), a parent company which is not a Public Interest Entity is required to rotate the audit of a subsidiary in another member state that is a Public Interest Entity under that state's definition.

In these circumstances it may be much more difficult for the group auditor to establish the strong, open communication between audit teams that is needed to ensure an effective audit. FEE supports the proposal in Article 27 (a) of the Eighth Directive that the group auditor should have full responsibility for the group audit opinion. However, mandatory rotation would make it very difficult for the group auditor to fulfil that duty in all circumstances.

Summary

The reduced audit quality and threats to objectivity described above are unacceptable to the public trust objectives of audit firms or the capital markets. In practice, many firms guard against them during an audit change through embedding professionalism in their people, appointing independent review partners and focusing on new audits in their quality control procedures.

However, it should be clear that a change of auditor introduces a number of new threats to quality which make these extra safeguards necessary. Where mandatory rotation is restricted to partners rather than firms, the audit team can phase changes so that their institutional knowledge is maintained, the threat to quality is minimised but the benefit of a periodic fresh look at the client's accounting is realised.

APPENDIX – STUDIES FOR CONSULTATION

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