Mandatory firm rotation: not the answer

There’s a perception of over-familiarity between the auditor and management that needs to be addressed, but enforced rotation is not the way to do that, argues Richard Sexton.

What’s going on?

When the European Commission proposed a package of legislative reforms aimed at reinforcing audit independence in November 2011, it set in motion a renewed debate on mandatory firm rotation, or MFR, worldwide.

In the UK, the Competition Commission investigated the dominance of the statutory audit market by four firms, and suggested MFR amongst its possible remedies in its ‘provisional findings’. In the US, the Public Company Accounting Oversight Board (PCAOB) has asked for input on questions of auditor independence including the possibility of MFR. And the Netherlands has enacted MFR – it will start in 2016.

You could be excused for thinking that mandatory firm rotation is a new idea– but it’s not. Some countries have previously adopted it – and some of those, such as South Korea and Singapore, have already abandoned it as unworkable. So for Europe as a whole to mandate MFR could put the EU at a competitive disadvantage. Our view on this is also supported by many investors and a large part of the European business community.

Why is it important?

Independence, objectivity and scepticism are at the heart of the audit profession, but there’s no doubt that there is a perception of over-familiarity between the auditor and management that needs to be addressed. But enforced rotation is not the way to do that – it is an inappropriate and disproportionate response.

Simply, mandatory audit firm rotation will put audit quality at significant, unnecessary risk. There are more effective, less disruptive and less costly ways to reinforce independence.

There are other ways of reinforcing independence and corporate governance, while at the same time maintaining choice and enhancing audit quality.

So why not MFR?

MFR reduces the quality of an audit, through loss of significant cumulative knowledge of the company’s business. This increases the risk of audit failure. It’s essential that an auditor’s familiarity with the business is not equated with over-familiarity with management. It also reduces an audit committee’s ability to fulfil its responsibilities. If the incumbent firm meets the needs of the audit client best, and the audit committee cannot choose this firm, the committee’s ability to fully discharge its oversight responsibilities is reduced. This in turn disenfranchises shareholders.

Some promote MFR as a way to increase competition in the audit market. But MFR actually reduces competition and restricts free market forces. Not only can the incumbent firm not bid to audit the client, but the Review of the EC impact assessment by Copenhagen Economics concluded that MFR may actually weaken competition, as companies gravitate towards a large firm upon rotation. In certain complex industries, such as oil and gas, and particularly global finance, MFR could have additional adverse consequences on competition.

Importantly, there are alternatives to MFR. The package of proposals from the European Parliament’s influential Legal Affairs Committee (JURI) contains some suggestions we agree with – including an annual audit quality review, carried out by the audit committee. But there are other ways of strengthening the audit market too, namely:

- Strengthen the role of the independent national regulators of the profession.
- Improve coordination and communication between regulators, auditors and audit committees.
- Make external audit inspection requirements more consistent to allow for greater comparability of inspection results.
- Closer involvement of the national audit regulators and supervisors in the appointment of the auditor under certain exceptional circumstances.
AUDITOR REPORTING

Further improvements might include more transparency about the audit and auditors:

- By the auditor to the audit committee about the conduct of the audit
- By the audit committee to the public about their oversight of the audit, including how they evaluate the performance of the auditor and the appointment/reappointment process
- By the audit firm to the public about its quality processes and additional commentary on companies.

These alternative solutions enhance oversight of the auditor, further promoting audit quality, while also reinforcing the role and responsibilities of the audit committee, as well as enabling better communication with regulators and shareholders.

It makes sense to explore new ways to enhance auditor independence and the broader objective of audit quality. On that point, everyone can agree.

But MFR isn’t the right way to do it, and it might have the opposite effect. MFR wouldn’t meet the stated aims of the legislators and regulators, nor would it answer the concerns of stakeholders. It would not be in the public interest.

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