**Point of View**

Mandatory audit firm rotation – other changes would be better for investors

**Key messages**

- There is no evidence that mandatory audit firm rotation would increase auditor independence or reduce over-familiarity. Nor would it enhance audit quality – on the contrary, the loss of knowledge, disruption and limitations on choice are likely to have the opposite effect.

- This idea is not new. A number of countries have experimented with and then rejected it. When the US PCAOB recently asked for views on mandatory rotation, more than nine out of ten respondents opposed it. In Europe, many audit committee members, Members of European Parliament, national regulators and governments have also made their opposition clear.

- There are more effective ways to reinforce auditor independence, objectivity and professional scepticism. For example, we support: stronger national regulators; better coordination and communication between regulators, auditors and audit committees; and greater consistency in audit quality inspection requirements. We also support increased transparency by auditors to audit committees, and by companies to the public.
Point of view

Objectivity, independence and professional scepticism are fundamental to audit quality. Making it mandatory for audit firms to rotate would not enhance audit quality.

Where are we now?
On 30 November 2011, the European Commission (EC) issued proposals for a new Regulation and Directive to reform the statutory audit market. These proposals included mandatory audit firm rotation, although many were opposed to the idea. According to an assessment of the responses to the EC’s 2010 Green Paper by Goethe University, only 17% supported mandatory audit firm rotation. The European Parliament (EP) also expressed its opinion that there are better alternatives in its resolution of 13 September 2011 on ‘audit policy: lessons from the crisis’.

In August 2011, the Public Company Accounting Oversight Board (PCAOB) in the US asked for input on questions of auditor independence. It specifically asked for views on mandatory audit firm rotation for all public company audits: over 90% of the initial 612 responses opposed it.

Why is this important?
Making it mandatory for audit firms to rotate is one of the options regulators are looking at as a way to improve the independence, objectivity and professional scepticism of auditors and to address the perception of over-familiarity between the auditor and management. We agree these attributes are at the heart of the audit profession. We should be looking for ways to improve independence safeguards and rules to increase investor confidence in the quality of our audits and companies’ financial reporting.

We believe that mandatory audit firm rotation will put audit quality at significant unnecessary risk and that there are more effective, less disruptive and less costly ways to reinforce independence. In many countries there are already effective safeguards in place and existing independence frameworks should be the foundation for any future improvements.

Why not mandatory audit firm rotation?
Proposals that advocate mandatory audit firm rotation have provoked widespread opposition from a broad range of capital market participants and relevant stakeholders. It is widely seen as the wrong approach – both inappropriate and disproportionate. There is a striking lack of evidence to support the suggestion that mandatory rotation increases auditor independence and audit quality. We believe it would have the opposite effect.

Companies are free to change their auditors when they choose, and the idea of forcing them to change is not new. Some countries have experimented with mandatory audit firm rotation, but most have rejected it. In the limited number of countries where audit firms are still required to rotate, there’s little or no evidence that it improves audit quality, auditor independence, objectivity or scepticism. Further, studies suggest that mandatory audit firm rotation at regular arbitrary intervals results in significant costs to companies that outweigh any perceived benefits and can increase the risk of audit failure.

It reduces the quality of an audit
Mandatory rotation of audit firms would result in the loss of the audit firm’s significant cumulative knowledge of the company’s business, people, processes, controls and risks, putting audit quality at significant unnecessary risk. It also increases the risk of audit failures – research shows that faulty audit work is more likely to occur in the first years after a new auditor takes over, when the auditor is less experienced and knowledgeable about the company. An auditor’s familiarity with the business and the environment in which it operates are essential to a quality audit – this should not be equated with over-familiarity with management.

It reduces an audit committee’s ability to fulfil its responsibilities
Audit committees (or others charged with governance) play a fundamental role in overseeing the audit and management’s relationship with the auditor. Mandatory audit firm rotation takes away the committee’s freedom to decide which audit firm best meets the needs of the company and its shareholders. It reduces the committee’s ability to fully discharge its oversight responsibilities and in turn disenfranchises shareholders. That’s why audit committees, and most of the investors they represent, have said they strongly oppose this approach.

1 M. Cameran, et al. (2003), Scuola di Direzione Aziendale dell’Università Bocconi: ‘A Survey of the Impact of Mandatory Rotation Rule on Audit Quality and Audit Pricing in Italy’
Objectivity, independence and professional scepticism are fundamental to audit quality. Making it mandatory for audit firms to rotate would not enhance audit quality. *Continued*

**It reduces competition and restricts free market forces**
Mandatory audit firm rotation reduces competition in the audit market, because the current auditor cannot compete, even if there is no better alternative. The ‘Review of the EC Impact Assessment’ by Copenhagen Economics concludes that mandatory audit firm rotation may weaken competition, as companies gravitate towards a large firm upon rotation, ultimately increasing concentration rather than reducing it. A similar assessment by the EP’s Impact Assessment Unit indicated that the EC’s proposed measures were excessive as they had not substantiated any distortion of the functioning of the audit market in Europe or that current market concentrations had led to impaired quality.

**It adds cost and complexity to audits**
Changing auditors on an arbitrary schedule, regardless of the company’s circumstances, will be disruptive for both the company and the auditor. For example, companies will be forced to spend extra time and effort managing the rotation process and bringing new auditors up to speed. The effect of this will be even more acutely felt by companies experiencing difficulty or going through significant corporate transactions. Any efficiencies achieved by, or lessons learned from, the previous auditor would be lost. And for multinationals, the need to appoint auditors around the world to comply with differing laws and regulations becomes even more complex. Existing studies cited in the ‘Review of the EC Impact Assessment’ by Copenhagen Economics show such effects can be substantial.

**It goes against market consensus**
Most countries do not have mandatory rotation for audit firms. Some have considered it, but rejected it. Others have adopted it, but later reversed it – for example, Brazil, Korea, and Singapore.

Italy is currently the only European Union member state that has retained its mandatory audit firm rotation requirement. In 2001 the SDA Bocconi Institute in Milan, began to study the Italian experience and found no empirical evidence that rotation had improved audit quality but did show that it had contributed significantly to the concentration of market share to the largest audit firms.

The vast majority of those who have spoken publicly about the recent regulatory proposals have opposed them. A clear majority of audit committees (and others charged with governance) have said they don’t believe it is an effective way to enhance audit quality.

**It has additional adverse consequences in certain industries**
The negative consequences of mandatory audit firm rotation can be even more significant for companies of significant size or that operate in complex industries, for example, oil and gas exploration and production companies, the extractive industries and, most particularly, large global financial institutions. By way of illustration we provide some specific examples of why mandatory audit firm rotation is bad for banks in Annex I – Why not mandatory rotation of audit firms for banks?

**What measures should be considered?**
There are already many detailed, complex rules in place to safeguard auditor independence that work well. But there are extra steps that could be taken to enhance audit quality and independence in the eyes of our stakeholders and which would address perceptions of auditor over-familiarity with management. In many countries some of those practices may have already been adopted and we believe they should be adopted consistently in all countries. Below we have listed measures that are not currently in widespread use. The impact of these measures may vary by country.

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2 It is recognised that on 11 December 2012 the Netherlands Senate voted to approve a new law reforming the Netherlands’ audit profession that included mandatory audit firm rotation, effective 1 January 2016.
Objectivity, independence and professional scepticism are fundamental to audit quality. Making it mandatory for audit firms to rotate would not enhance audit quality. Continued

Strong, independent national regulators of the profession

- Better coordination and communication between regulators, auditors and audit committees – to build a more mutual, consistent and effective approach; for example, allowing further opportunity for auditors to raise any concerns about risk and financial reporting developments with regulators; regulators providing information to the market to help identify systemic issues; and putting in place protocols to mitigate the impact of a large company collapse.
- More consistency in national external audit inspection requirements – to drive higher quality and stricter oversight and to allow greater comparability of public inspection results of firms by market participants.
- Exploration of ways to facilitate closer involvement of national audit regulators and supervisors in the audit committee’s appointment of the auditor under certain exceptional defined circumstances.

Transparency about the audit and the auditors

- By the auditor to the audit committee – about the general conduct of the audit (including: process, methodology, scope and materiality, accounting estimates and judgements made by management, fraud and other risks).
- By the audit committee to the public – about the oversight of the audit and the nature of information provided, including:
  a) how it evaluates the performance of the auditor, the criteria and timetable it uses for assessing whether to retender the audit, the basis on which it recommends the auditor for appointment/reappointment, how it decides which non-audit services the auditor can provide for what fee, and how the auditor complies with the rules and laws on independence.
  b) additional relevant financial reporting and disclosures, for example, about matters that could affect the going concern assumption such as evaluation of key risks.
- By the audit firm to the public – about quality (including: quality-control arrangements, compliance with independence requirements, application of objectivity and professional scepticism) and disclosure of more relevant commentary on companies such as the operation of risk controls.

Stronger governance by the audit committee (or others charged with governance)

- Make it mandatory for audit committees to regularly reassess their auditors’ effectiveness, independence and objectivity on an appropriate periodic basis, including the independence of their relationship with management.
- Agree an audit committee charter, with criteria for appointing auditors and reviewing and approving all non-audit services.
- Evaluate recent changes to accounting standards by regulators (and make sure they are applied).
- Assess overall results of the auditor’s internal and external audit inspections.
- Draw up minimum mandatory competency requirements for audit committees.

Restrictions on non-audit services (see also our Point of View on ‘auditor’s scope of services’)

- All those non-audit services that present an insurmountable threat to independence should be prohibited even if that results in additional restrictions in some territories.
- Restrictions should be based on principles that evolve to meet the ever-changing needs of the market rather than inflexible lists of permitted services that can quickly become obsolete.
- Approval and/or review by the audit committee of non-audit services provided by the auditor.

There are certain specific measures that might be considered in the banking and financial services sector that we believe would enhance audit quality and independence and have recommended in Annex II – What are the alternatives to mandatory firm rotation for banks?

In these ways, oversight of the auditor could be enhanced to further promote audit quality whilst also reinforcing the role and responsibilities of audit committees and
enabling better dialogue and communication with regulators and shareholders. When combined with the efforts of the International Auditing and Assurance Standards Board (PwC IAASB Response) to enhance the audit report we believe these measures and our proposals represent a more effective means of addressing the perceived problems than mandatory audit firm rotation.

**In conclusion**

We believe mandatory audit firm rotation will put the quality of audits at significant unnecessary risk and compromise the reliability of financial reporting. We believe it undermines recent reforms that have improved audit quality such as enhanced audit committee oversight of the relationship between company and auditor. Most commentators and those national authorities that have abandoned mandatory audit firm rotation share our views.

Exploring new ways of enhancing independence and the broader objective of audit quality makes sense. On that point all can agree. But mandatory audit firm rotation is not the right way to do it. It may, in fact, have the opposite effect. Neither would it meet the stated objectives of legislators and regulators, or the concerns of stakeholders. It would not be in the public interest.

These considerations highlight significant concerns about mandatory audit firm rotation. We believe the introduction of a mandatory regular reassessment of auditor objectivity, effectiveness and independence would be more effective and less disruptive, with the added benefits of reinforcing independence and corporate governance, maintaining choice, and enhancing audit quality.

This Point of View forms part of a series which sets out our views on a range of key issues impacting the statutory audit. These are available at: www.pwc.com/regulatory-debate, and also include:

- **Independence**: at the heart of who we are.
- **Auditor’s scope of services**.
- **Governance and transparency** of the audit: a critical role for the audit committee.
- **Benefits of scale**: the context and the explanation.
- **Competition and choice** in the audit market.

Objectivity, independence and professional scepticism are fundamental to audit quality. Making it mandatory for audit firms to rotate would not enhance audit quality. *Continued*
Annex I – Why not mandatory rotation of audit firms for banks?

Why is this important?
Certain stakeholders have suggested that mandatory audit firm rotation should be adopted specifically for banks because of their importance to the capital markets and their role in the financial crisis. Others suggest it for financial institutions more broadly. We have outlined why we believe mandatory audit firm rotation will put audit quality at significant unnecessary risk and undermine the reliability of financial reporting for any company. However, for larger, more complex companies, and in particular the banking industry, the adverse impact is likely to be even more severe.

What do we believe?
We believe that experimenting with mandatory audit firm rotation in the banking sector is likely to result in serious adverse consequences.

Audit quality will be threatened – the risks outweigh any perceived benefits
The institutional knowledge, skills and experience required to perform a high-quality audit of a large, complex and global bank are not easily or quickly replicated. The audit firm must have sufficient experienced staff in all the countries in which the bank operates to perform a quality audit and to meet partner rotation and quality review requirements.

A deep understanding of the businesses being audited is critical to audit quality – particularly to audit the many complex judgements reflected in a bank’s financial statements. These include, for example, the appropriate level of impairment allowance, the valuation of illiquid instruments, the accounting for structured transactions, and the assessment of disclosures of financial risks that are of themselves increasingly complex.

The prior auditor’s cumulative knowledge of the bank’s risks, processes, controls and culture will be lost. Newly-appointed audit firms do not generally have detailed broad-based experience with the new company they are to audit and may not initially have all the expertise required to audit it. As a result, regular changes of the audit firm may put audit quality at significant unnecessary risk and compromise the ability of the new firm to detect misapplication of policies and processes by management, by error or fraud. Whilst these risks can be managed for individual bank auditor changes that already occur, the impact of broad rotation rules will significantly increase transition risks. Such rules will severely challenge the ability of audit firms to manage multiple auditor rotations on a global scale.

Mandatory firm rotation in Europe will have detrimental effects worldwide
Most large global banks engage one audit network that has common audit methodologies and communication tools to facilitate and enhance consistency and quality around the world. If global banks were required to rotate their auditors in one part of the world, they would be forced to either engage multiple auditors across the group, or change their audit network globally on an arbitrary basis irrespective of who is best placed to do the work. Neither option enhances audit quality. For the largest and most complex banks that operate global businesses, having a number of auditors across their major operations is likely not feasible: the auditor has to have access to all major operations in order to have a sufficient understanding of cross-border transactions, management processes and risks and controls to deliver a quality audit. Even if multiple auditors were a realistic option (which in general we do not think it is), the increased risks of significant issues slipping between the cracks is substantial.

It will distract an industry that currently faces extraordinary challenges
Banking is a heavily-regulated, complex industry with unique features, and it is still not yet out of crisis. Significant regulatory changes and challenges are underway including ‘Basel III & the Fourth Capital Requirements Directive’ (CRDIV), the ‘Dodd Frank
Annex I – Why not mandatory rotation of audit firms for banks? Continued

Act’, and the potential structural ring-fencing of certain wholesale and retail services, and more are anticipated. Experimenting with mandatory audit firm rotation in the midst of such pressures would certainly add risk to an unstable environment – unnecessarily distracting the bank’s operational and risk management, its financial reporting leadership and those charged with governance.

It will pose challenges to auditor independence, reduce the company’s choice of audit firms and restrict competition in the audit market

In all industries, mandatory rotation of audit firms reduces competition in the audit market as the incumbent audit firm cannot compete, even if it is the firm most likely to provide the highest quality audit. In banking, this is of particular concern because of the knowledge and skills required to deliver a high-quality audit.

The challenges of achieving and maintaining independence are substantially more complex and costly for banks than companies in other industries. The independence rules are complex and inconsistent around the world. Major international banks typically provide banking services to firms that are not their auditor, and often provide impermissible services to their partners, employees, and their spouses and other relatives. Banks cannot provide these services to their audit firm no matter how insignificant the value. A change of auditor would require the new audit firm, its partners and many of its employees, to establish alternative banking arrangements.

For large global banks, this may rule out one or more audit networks. This would further limit the choice of alternative audit providers and increase costs to the banks, perhaps significantly.

Independence is also affected by the specialised non-audit services that banks need in order to address their complexity and the regulatory requirements they face. The large audit networks are among the largest providers of these services (to the banks they do not audit) because of their specific skills, principally in risk, regulation and controls. Independence rules already require the new audit firm to immediately cease any services that conflict with auditor independence and in some cases require a specified period to achieve independence. This often cannot be done quickly or may prevent an audit firm from seeking the work altogether, further restricting choice in the market for these important services.

There is no evidence, or prior experience, that it will improve audit quality or prevent a financial crisis

There is neither evidence nor experience that the consequences of the financial crisis would have been prevented or reduced by mandatory audit firm rotation or that it will improve audit and financial reporting quality for banks. In fact, many countries, such as Brazil, Korea, and Singapore, have recently abandoned mandatory audit firm rotation either specifically for their major banks or for all companies.
Why is this important?

The banking industry currently faces enormous business and regulatory challenges. Introducing mandatory audit firm rotation would place additional strain on its ability to meet these challenges and may well undermine the benefits of these changes.

There are however other measures that we believe would be more effective and less disruptive for banks and other financial institutions. Such measures would reinforce independence and corporate governance, maintain choice, and above all, enhance audit quality. They would also provide financial supervisors (and auditors) with better information thus enhancing the overall quality of financial supervision.

What do we propose?

In addition to what we have outlined in our Point of View, we believe a range of other measures could enhance the quality of banking audits specifically. These measures, which should be debated and developed further alongside other measures of audit and banking reform, include:

1. Additional powers and responsibilities for banking regulators and supervisors to assess:
   a) Audit committee oversight – consistent assessment of the processes adopted by audit committees in their oversight of audit quality, including audit appointment processes.
   b) Individual bank-specific risks – knowledge sharing and collaboration between auditors and supervisors relating to individual banks risks.
   c) Systemic, macro industry risks – increased dialogue with audit firms at the national and supra-national level regarding specific accounting and auditing issues and emerging macro industry risks impacting financial stability.

2. Continued engagement of stakeholders in a meaningful debate focused on enhancing relevant financial reporting, disclosures and assurance for banks, including:
   a) Greater clarity about the information banks and their auditors provide to markets.
   b) Improvements in the current bank reporting framework, including our support for the Enhanced Disclosure Task Force (EDTF) of the Financial Stability Board, and more consistent and relevant information describing the risk management process and controls in place at a bank.
   c) Disclosures about matters that could affect the going concern assumption – for example, consideration of recommendations set out in the UK Sharman report.

3. Increased dialogue between auditors and the risk committees of banks they audit.

The benefits of these measures, weighed against the likely significant and detrimental effects of mandatory firm rotation, should be debated and considered before experimenting with legislation in such a systemically important industry.

Annex II – What are the alternatives to mandatory firm rotation for banks?

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