

## Reviewing rotation

By Tracey C. Ball, Jonathan Glover, Karim Jamal, Rozina Kassam, Ken Kouri, Kouri Berezan Heinrichs, Suresh Radhakrishnan, and Shyam Sunder

Illustration: Ryan Snook



### Is mandatory rotation of audit firms the answer to promote independence and to improve audit quality?

Auditor independence, objectivity and skepticism are necessary for proper functioning of capital markets. In the hope of achieving this ideal of auditor independence, regulatory agencies in the EU and the US proposed mandatory rotation of audit firms through exposure drafts issued in mid-2011. Potential effects of the procedures used to select and appoint auditors have long been of concern with respect to real and perceived independence and objectivity of auditors (e.g., Mautz and Sharaf 1961). Enhancing perceived and actual auditor independence is a worthy objective for public policy. However, academic research and practical experience suggest that attempts to achieve this increased independence through mandated rotation of audit firms is likely to have other unintended and undesirable consequences. It would be prudent for public policy to consider the balance between all consequences of the proposed auditor rotation.

The quality of audit is determined by auditor independence and also by many other factors, including quality of accounting standards, accounting education, auditor expertise, audit committees, corporate governance, auditor discipline, liability and a host of institutional features of the audit environment. Attempts to promote some of these desirable attributes of audit often degrade others, making a perfect audit an unattainable dream. Public policy, therefore, should aim for the best audit quality and not fixate on any subset of the determinants of audit quality. Existing research leads us to conclude that, in spite of its obvious appeal, mandating audit firm rotation would be a bad policy. Such a change may impair auditor independence, weaken audit expertise and undermine corporate governance.

### Rotation and auditor objectivity

The proposal to mandate auditor rotation is based on the belief that it promotes objectivity because new personnel (or audit firms) are not tied down by judgments, compromises and past relationships. A new auditor brings a fresh set of eyes and has the opportunity to raise issues that in the past have been overlooked or settled. Consistent with this view, academic research shows that new auditors are better able to identify issues, alter their judgments and bring issues up for discussion when they are not personally committed to prior decisions (see Tan, p.

113-35 in Spring 1995 issue of Journal of Accounting Research). While a fresh look at issues that might have been overlooked by the existing auditor, or settled improperly in favour of the client, supports rotation, mandated rotation also creates the possibility of some important issues being overlooked by new auditors or settled improperly in favour of the client. Besides, there are other features of the audit market that might undermine the potential advantages of auditor rotation.

A recent academic research study by Fiolleau et al. (2010) shows that although regulations require auditors to be appointed by the audit committee of the board of directors of the client company, the management plays a significant role in the process and may even dominate it. A mandate for audit-firm rotation will force the incumbent and potential auditors into a beauty contest, or bidding war, every few years. The market power of audit firms is so much weaker than the power of their clients that at the time of bidding for engagement the former compete among themselves to convince management and the audit committee of their potential clients of their commitment, service, cultural fit and responsiveness. In this environment, each hiring exercise becomes an opportunity for opinion shopping by clients, lowballing of audit fees and demonstrations of loyalty and solicitous relationship-building by the auditors. Many auditor behaviours that the proposed rotation mandate is intended to discourage get exacerbated when the audit firm enters into a beauty contest to get an audit engagement.

While there is enough competition among auditors that auditor rotation is likely to produce beauty contests, it is questionable if there is enough competition to allow for a true fresh look. Fiolleau et al. (2010) report their observations on the consequence of the audit market being concentrated in the hands of just four large international firms. Most large clients already receive one service or another from every one of the four firms. If one of these accounting firms audits the client, the other three often provide it a host of advisory services in tax, valuations, etc. The perpetual engagement and pre-existing relationships between most large companies and all four major audit firms implies there is only limited opportunity for mandatory rotation to bring about a fresh look. The US General Accounting Office (2003) study on mandatory audit firm rotation estimated increased initial audit costs of more than 20% (some studies in Europe suggest 40%), which did not include costs incurred by the audit committee and management to conduct the tendering process.

Finally, noting that familiarity arises between individuals (e.g., the audit partner and the CFO), not firms, a large part of the benefits of taking a fresh look may be obtained by rotating the partner and/or other senior personnel on the audit team. Since the policy of partner rotation is already in place, audit-firm rotation is unlikely to add any significant marginal benefit, especially when the considerable costs of firm rotation are taken into account.

Thus regulatory proposals to mandate audit-firm rotation are likely to yield little by way of benefits and incur the additional harm associated with increased frequency of beauty contests, which undermine auditor independence.

### **Rotation and auditor expertise**

There is compelling evidence in academic research that audit- firm rotation will impair auditor expertise. The Public Company Accounting Oversight Board's (PCAOB) concept paper indicates awareness that the auditor is most vulnerable to missing fraud in a new engagement (see also St. Pierre and Anderson, p. 242-63, Vol. 59(2), 1984, *The Accounting Review*). Other studies (e.g., Myers et al., p. 779-799, Vol. 78, July 2003, *The Accounting Review*) show that the quality of accounting numbers is associated with increases in auditor tenure. The most compelling force associated with accounting accruals is auditor industry expertise (Craswell et al., p. 297-322, December 1995, *Journal of Accounting and Economics*). Collectively, this suggests that a policy of mandatory auditor rotation could undermine accretion of expertise and impair audit quality.

The thrust of generally accepted accounting principles (GAAP) is increasingly oriented to having management communicate to investors how they operate the business. Auditors' understanding of the substance of client business would be undermined if they are rotated every few years. The Fiolleau et al (2010) study reveals that even the four largest audit firms lack depth of expertise in serving large corporate clients across all industries outside main business centres such as Toronto, Montreal, Calgary and Vancouver. For clients with headquarters in smaller cities, finding industry specialists in local offices can be a significant challenge.

### **Improving audit quality**

Audit quality is not just an attribute of the auditor alone. The nature of GAAP is also a major determinant of audit quality. Over recent decades, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have set standards that de-emphasize verifiability in favour of the mark-to-market valuation, no matter how illiquid the market may be. It has also adopted a practice of writing detailed standards in its attempt to close loopholes, but ends up creating new ones. For example, exploitation of the special purpose entity rule by Enron a decade ago and of the Repo 105 rules by financial-services firms during the recent crisis illustrate how detailed rule writing leads to improper reporting. This type of standards place auditors in a difficult position vis-à-vis corporate management. The shift in GAAP toward the so-called "fair-value accounting" is a major factor undermining audit quality. Auditor rotation is not likely to help improve audit quality when the underlying accounting quality is questionable. On the contrary, it will simply create more opportunities for determined clients to conduct opinion shopping without having to fire their auditors.

### **Importance of audit resignation as a signal**

When the financial press report that company X, audited by firm Y for the past 20 years, has changed its auditor, investors get an informative warning signal that draws scrutiny by the investment and regulatory communities. PCAOB's mandatory rotation proposal will routinize and therefore reduce the saliency of this important signal. Less attention and scrutiny given to such signals will undermine the quality of audit.

### **Transfer of audit resources from verification to marketing**

The mandate for audit-firm rotation will induce audit firms to shift more resources to marketing themselves to potential clients. These resources can only come from cutting back on the substantive work of verification during the course of their audits or by raising audit fees. Individuals in the audit firm will find their presentation and marketing skills becoming more valuable relative to their technical accounting and auditing skills.

### **Confusion from too many initiatives**

Auditors work in a complex economic and social environment. There are economic incentives to be responsive to management but these have to be balanced with incentives emanating from audit committees, concurring review partners, national office reviews, litigation, GAAP and industry practice, and PCAOB/Canadian Public Accountability Board reviews. In some countries two audit firms jointly conduct an audit, making it difficult for any single audit firm to have consistency in its audits across countries as complex coordination is required across audit firms. Fraud cases such as Parmalat went undetected due to a lack of continuity of the auditor and presence of multiple audit firms. Adding more agents and incentives into this mix serves to further complicate incentive structures, and could create interpersonal friction and potential for unintended consequences as accountability and authority get dispersed across a variety of agents. This increases moral hazard and the potential for confusion. Adding one more mandate of audit-firm rotation is likely to add to the confusion.

### **Conclusion**

Audit-firm rotation is a poor instrument to promote independence, especially in an environment where auditors are appointed by board audit committees with participation of management. The potential benefits of rotation seem likely to be exceeded by the harm associated with the beauty contest during the auditor-hiring process. Rotation actually impairs audit quality by enabling more frequent opinion shopping and lowballing. Rotation also discourages accretion of audit expertise, downgrades the valuable signal of auditor change, and shifts even more resources from substantive verification and tests to marketing of audit services. Most of the benefits of rotation can be realized by rotating the engagement partners. Given the limited independence of most audit committees from the management, improving audit quality through firm rotation may simply not be possible. A more fruitful approach is for the FASB/IASB to rethink their approach to writing standards of financial reporting, so as to enhance the verifiability of financial reports and improve accounting and audit quality.

---

*Tracey C. Ball, FCA ICD.D, is executive vice-president & CFO, Canadian Western Bank Group; Jonathan Glover, PhD, is professor of accounting, Carnegie Mellon University; Karim Jamal, FCA, PhD, distinguished chair, department of accounting, operations and information systems, professor, U of A (and CAmagazine's Education technical editor); Rozina Kassam, CA, is CFO, Commercial Solutions Inc.; Ken Kouri, FCA, is a retired partner, Kouri Berezan Heinrichs; Brad Paterson, CMA, is CFO, Wave Front Technology Solutions; Suresh Radhakrishnan, PhD, is*

*professor of accounting, University of Texas at Dallas; and Shyam Sunder, PhD, is James L. Frank professor of accounting, economics and finance, Yale University.*