THE POTENTIAL FOR MANDATORY AUDITOR ROTATION: A PRELUDE FOR CHANGE IN AUDIT FIRM, CLIENT COMPANY RELATIONSHIPS

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ABSTRACT

In response to the widespread and financially devastating business scandals (Enron, Adelphia, HealthSouth, and WorldCom, to name just a few) that took place during 2001 and the first half of 2002, Congress passed the Sarbanes-Oxley Act ("SOX" or "the Act") on July 30, 2002. This act was designed to address accounting reform, improve corporate governance, and restore investor confidence. The depth and breadth of SOX's legislative coverage provide a basis to support broad reform within the auditing profession. Within Title II (Auditor Independence) of the Act is a small three-paragraph section that has the potential to change the way the auditing profession interacts with client companies.

Section 207 of the Act required a study of the potential impacts of requiring mandatory rotation of audit firms for publicly held companies. In November 2003, the General Accounting Office (GAO) delivered the results of this study to the Senate Committee on Banking, Housing, and Urban Affairs and to the House Committee on Financial Services. This paper discusses the study and several audit firm, client company issues related to the potential for mandatory rotation.

Auditor Independence

The concept of auditor independence has always consisted of two parts: independence in fact and independence in appearance. Independence in fact reflects a state of mind, while independence in appearance reflects an external assessment. Both elements of independence must exist: the public (assuming the reasonable person standard) cannot perceive that an auditor or an audit firm is biased or has conflicting interests with the client company. If independence in appearance is tainted, the sense of confidence that the audit opinion was designed to engender will be diminished.

Although most audit firms would assert that both aspects of independence are stressed at all personnel levels, auditors may find it difficult to interpret the true priority parameters if the firm is sending mixed messages. Auditors must attempt to interpret the rules of professional conduct within the context of their perceptions about the audit firm's objectives relative to client engagements. Is the audit firm's objective to perform the best audit possible, retain the audit client company, increase audit revenues, reduce audit billable hours, or detect misleading, inappropriate or fraudulent accounting practices? Unfortunately, each of these objectives is reasonable—and yet potentially in conflict.

Sarbanes-Oxley has dramatically changed the relationships between auditors and client management. One CFO remarked, "only half jokingly," that he didn't consider the auditors his "friends anymore" (O'Sullivan, 2004a).

In an attempt to minimize the potential for lack of independence in appearance (or a true lack of independence in fact), Section 203 of SOX stated that the lead, coordinating, or reviewing audit partner

must be rotated from an audit engagement every five years. Such a rotation process was designed to reduce the possibility that the audit partner and members of client management would develop improper, non-independent relationships with one another. However, given that professional standards already required such a rotation process, Congress was not certain that mandated partner rotation was sufficient to preclude public concerns about audit firm independence—in either fact or appearance—from clients.

Results of the GAO Study on Mandatory Auditor Rotation

In developing the independence provisions of SOX, testimony to Congress was heard on the positive and negative implications of instituting mandatory rotation of audit firms relative to client companies. Mandatory rotation implies that an explicit limit is placed on the time during which a specific audit firm may be the auditor of record for a specific client company. The maximum time limit for the rotation process has not been indicated.

Although the issue of mandatory audit firm rotation has previously been investigated (and rejected) by both the Securities and Exchange Commission and the Committee of Sponsoring Organizations of the Treadway Commission, the Comptroller General of the United States through the auspices of the General Accounting Office was required under Section 207 of SOX to perform a study about mandatory rotation.

Arguments in Favor of Mandatory Auditor Rotation

Individuals who support mandatory audit firm rotation contend that pressures faced by the incumbent audit firm to retain the client company could adversely affect the auditor's actions to appropriately deal with financial reporting issues that materially affect the company's financial statements. The fewer adjustments that need to be made to the financials and the more quickly (thus, less expensively) the audit can be performed, the more satisfied the client company is with its chosen audit firm (and individual employee auditors), the more likely it is that the auditing firm will retain the client and the individual auditors will have continued future employment, and the stronger the auditor-auditing firm-audit client relationship becomes. In other words, “auditors have strong business reasons to remain in clients’ good graces and are thus highly motivated to approve their clients’ accounts” (Bazerman et al., 2002).

A second argument in favor of mandatory audit firm rotation is that it would increase the public’s *perception* of auditor independence—in other words, the element of independence in appearance would be raised.

A third reason in favor of mandatory rotation is that it would allow audit firms to be more vocal about disagreeing with questionable client practices. Knowing that a client company would only “belong” to the audit firm for a limited period of time, the firm would not be risking a ‘perpetual’ revenue stream by agreeing to overly aggressive practices, deterring ‘questionable’ judgments, or taking compromise positions on recording business transactions (Conference Board, 2003:34).

A fourth reason in favor of mandatory rotation is that it would, to a limited extent, help level the playing field for audit firms.

Finally, knowing that another audit firm would, at some specific future time, be reviewing the financial statement judgments made by the current audit firm would simultaneously create some internal pressure to be less amenable to potential client manipulations.

Arguments against Mandatory Auditor Rotation

It is no wonder that terms such as *client entrenchment*, *vested interests*, and *fraternization* have proliferated through the recent corporate audit scandals: the GAO survey indicated that the average auditor tenure at Fortune 1000 public companies was 22 years. The accounting profession and many others abhor the concept of mandatory auditing firm rotation for a variety of reasons.

First, those in opposition contend that the new auditor's lack of knowledge of the company's operations, information systems that support the financial statements, and financial reporting practices will dramatically reduce audit quality.

The learning curve issue is a primary causal factor in the second reason against mandatory rotation: an increase in costs within the audit firm so that personnel can get “up to speed” on engagement issues and a corresponding increase in audit fees for the client company to compensate for the additional audit staff time.

Third, the learning curve is also cited as a crucial source of increased risk of audit failure in the initial years of an audit engagement, during that time needed to acquire the knowledge of financial reporting issues that could materially affect the client company's financial statements.

A fourth reason against mandatory rotation relates to the number of audit firms that have the quantity of personnel, depth and breadth of industry expertise, or merely the name recognition to satisfy large domestic and international client companies.

Fifth, those opposed to mandatory rotation point to the fact that the new Sarbanes-Oxley independence requirements have not had a reasonable amount of time to be fully implemented.

Sixth, even without compulsory rotation, new hires and the normal attrition of personnel within a given auditing firm will cause the audit team on an engagement to change over time.

Seventh, the potential shifting of auditors from one client to another is a reason against mandatory rotation. Many audit firm respondents to the GAO survey indicated that they would shift “their most knowledgeable and experienced audit personnel” from a current engagement to another audit as the end of the rotation period neared—even though they believed that reassigning these individuals “would increase the risk of an audit failure” (GAO, 2003).

Finally, there is the issue of global credibility. At present, mandatory audit firm rotation for public companies is required only in Italy, Brazil, and Austria; Singapore requires audit rotation for banking engagements.

After hearing arguments on both sides of mandatory audit firm rotation, the GAO report indicated that audit firms, client companies, and managers of audited companies must have a reasonable amount of time to adjust to the numerous changes that were mandated by Sarbanes-Oxley. Surveys by the GAO of the largest public accounting firms and the Fortune 1000 publicly traded companies indicate both believe that the costs of mandatory audit firm rotation are likely to exceed the benefits.