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**Meeting:** IESBA  
**Meeting Location:** IFAC Offices, New York, USA  
**Meeting Date:** June 18-20, 2012

## **Strengthening Safeguards Against Familiarity Threats**

### **Objective of Agenda Item**

To provide information that can assist the IESBA in determining what its position is on mandatory audit firm rotation (MFR), and other possible safeguards as a means of reducing to an acceptable level the familiarity and self-interest threats that can be created as a result of an auditor's long association with an audit client. The Code presently addresses those threats by requiring rotation of key audit partners on the engagement team when the audit client is a public interest entity. At its meeting in February 2012, the IESBA decided it should consider these measures, including whether the Code's partner rotation requirements continue to be appropriate. The board agreed its analysis should be guided by an overarching objective of improving audit quality.

### **Background**

#### *Europe*

In October 2010 the European Commission (EC) issued a Green Paper *Audit Policy: Lessons from the crisis*, in the aftermath of the 2008 global financial crisis. The EC wished to examine the role of the audit in the general context of financial market regulatory reform. The paper stated "the fact that numerous banks revealed huge losses... raises not only the question of how auditors could give clean audit reports to their clients for these periods but also about the suitability and adequacy of the current legislative framework. It seems thus appropriate that both the role of audit as well as the scope of audit are further discussed and scrutinized."

In the context of this objective, the EC examined the independence of audit firms (quotations from the Green Paper):

"Independence should be the unshakeable bedrock of the audit environment."

"Notwithstanding the legal provisions as well as the Code of Ethics..., the Commission would like to reinforce the independence of auditors and address the conflicts of interest which are inherent to the current landscape characterized by such features as... low levels of audit firm rotation..."

"Situations where a company has appointed the same audit firm for decades seem incompatible with desirable standards of independence... In this context the mandatory rotation of audit firms – not just of audit partners – should be considered."

“In a study in 2006 more than half of the respondent companies reported that their auditor has served the company for more than 7 years, and 31% reported that the change of an auditor has not occurred for more than 15 years; the general tendency is the bigger the audited company, the lower the switching rate.”

The IESBA submitted a response letter on the EC Green Paper (and on the PCAOB concept release discussed below) but did not express a view on mandatory firm rotation as the topic has not been the subject of the board's due process and deliberations.

The proposed regulations were issued in November 2011, and a vote on the regulations is expected in 2013. The proposals have a dual objective of changing the audit market to increase competition and strengthening the independence of auditors. They include mandatory rotation of audit firms after six years (eight years in exceptional circumstances) or after nine years for a joint audit (12 years in exceptional circumstances); a cooling-off period of four years; and partner rotation every seven years with a three year cooling-off period.

If passed, the regulations would become law throughout the European Union and apply to the audits of public interest entities (PIEs). At this stage it is uncertain whether the proposed regulations (and a related proposed directive) will pass in their present form.

## USA

In August 2011 the PCAOB issued a concept release to solicit public comment on ways that auditor independence, objectivity, and professional skepticism could be enhanced. Mandatory audit firm rotation was offered as a possible approach.

In 2002 the US Congress considered MFR as part of the debates that led to the Sarbanes Oxley Act of 2002. It decided the idea needed more study and requested a report, which was issued in 2003 by the US Government Accountability Office (an independent, non-partisan agency that works for the US Congress). The report concluded that MFR “may not be the most efficient way to enhance auditor independence and audit quality” and “more experience needs to be gained with the [Sarbanes Oxley] act's requirements,” which are “intended to achieve the same type of benefits as mandatory audit firm rotation.” The PCAOB stated:

“What is clear from the Board's inspections, as well as from the experiences of other regulators, is that questions persist about whether more can and should be done to enhance auditor independence, objectivity and professional skepticism.”

The PCAOB explains its underlying concerns when it says “the Board continues to find instances in which it appears that auditors did not approach some aspect of the audit with the required independence, objectivity and professional skepticism.” It is considering whether new approaches could foster a more fundamental shift in the way the auditor views its relationship with its audit client. It says that “auditor independence remains subject to a significant inherent risk. The accounting firm is a for-profit enterprise that is paid by the company being audited.”

PCAOB Chairman Doty referenced anecdotal cases in a speech in June 2011, although he said the views were his and not those of the PCAOB:

“In one case, an engagement partner helped his client avoid the possibility that an earnings announcement would have to be retracted after an overstatement was

discovered shortly before the company intended to file. As the company looked for last-minute accounting adjustments that might offset the errors, the audit response to the situation included the partner initiating a 50-percent increase in the firm's planned tolerance for misstatements. The company had been a client of the firm for 98 years.”<sup>1</sup>

PCAOB Chairman Doty recognized that the conduct he described in the examples above would be a problem no matter how long or short the auditor's tenure. The PCAOB is exploring whether MFR would reduce the likelihood of such instances while recognizing that it is not possible to demonstrate that so-called "audit failures," where audit regulators conclude upon inspection of an audit that more or different audit procedures should have been performed, are the result of long tenure:

“Indeed, it is precisely because of the inherent difficulty in isolating a link between a questionable influence and a compromised audit that any resolution of this issue must rest on our informed judgment rather than a mathematical certainty.”

The PCAOB received around 600 responses to the concept release, with most respondents comprising audit committee members and preparers. It has been widely reported that the majority of the responses opposed MFR. The PCAOB held a roundtable meeting in March 2012 to gather more feedback, and discussions are expected to continue into 2013.

## **IESBA Consideration**

The principal threats that mandatory firm rotation is intended to address are familiarity and self-interest. A familiarity threat is the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work (100.12(d)). A self-interest threat is the threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behavior (100.12(a)).

The Code recognizes that long-standing audit relationships can create both types of threats, which can undermine confidence in the independence of the auditor. However, there is a lack of evidence that such threats, when created by long-association, have led to deficient audits. The IESBA has agreed that its analysis of the issue should be guided by an over-arching objective of improving audit quality, in addition to independence, objectivity and professional skepticism.

Three ways of addressing these threats have been discussed in various debates in Europe and the US:

- Partner rotation
- Audit firm rotation
- Audit firm re-tendering

To facilitate the IESBA's consideration of the issue, this paper summarizes the Code's current position on partner rotation, and then examines the major arguments for and against audit firm rotation and re-tendering.

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<sup>1</sup> [http://pcaobus.org/News/Speech/Pages/06022011\\_DotyKeynoteAddress.aspx](http://pcaobus.org/News/Speech/Pages/06022011_DotyKeynoteAddress.aspx)

## *Audit Partner Rotation*

The Code currently addresses the familiarity and self-interest threats created by long association by requiring partner rotation (290.150 – 290.155):

"In respect of an audit of a public interest entity, an individual shall not be a key audit partner for more than seven years. After such time, the individual shall not be a member of the engagement team or be a key audit partner for the client for two years. During that period, the individual shall not participate in the audit of the entity, provide quality control for the engagement, consult with the engagement team or the client regarding technical or industry-specific issues, transactions or events or otherwise directly influence the outcome of the engagement." (290.151)

The 1998 Code stated "The use of the same senior personnel on an audit engagement over a prolonged period of time may pose a threat to independence" but also noted that "professional relationships take time to develop, but once developed, they usually lead to maximum efficiency and effectiveness.

Lead engagement partner rotation after seven years on the engagement with a time-out period thereafter of "normally two years" was introduced in 2001 for audit clients that are listed entities. The 2005 Code extended the requirement to the engagement partner and the individual responsible for the engagement quality control review and made the two-year time-out period mandatory.

The extant Code applies the requirement to key audit partners, which is defined in part as: The engagement partner, the individual responsible for the engagement quality control review, and other audit partners, if any, on the engagement team who make key decisions or judgments on significant matters with respect to the audit of the financial statements on which the firm will express an opinion.

When it was chosen in 2005, the seven-year on/two-year off requirement reflected an appropriate benchmark at that time. For example, it was the approach taken by the EU in its 8th Directive. However, today only a few major jurisdictions in the G20 utilize a 7 and 2 approach; the current rotation requirements in the G20 jurisdictions are summarized below.

<b>Jurisdiction</b>	<b>Partner Rotation</b>	<b>Partner Rotation</b>
	<b>Term</b>	<b>Cooling Off</b>
<b>IESBA CODE</b>	<b>7</b>	<b>2</b>
Argentina	5	5
Australia	5	2
Brazil	5	3
Canada	7	5
China	5	2
France	6	2
Germany	7	2

<b>Jurisdiction</b>	<b>Partner Rotation</b>	<b>Partner Rotation</b>
	<b>Term</b>	<b>Cooling Off</b>
India	7	2
Indonesia	3	2
Italy	7	3
Japan	5	5
Mexico	5	2
Russia	7	Not stated
Saudi Arabia	3	Not stated
South Africa	5	2
South Korea	3	3
Turkey	5	2
United Kingdom	5	5
United States	5	5

Note: The rotation requirements that apply in the countries above have been simplified for the purposes of comparison but typically apply to lead engagement and EQCR partners with respect to their audits of the financial statements of PIEs. The rules may vary by industry sectors and sizes of companies. Additionally, the definition of the partner(s) to whom the partner rotation requirements apply may vary between jurisdictions, e.g. lead engagement partner, key audit partner, lead partner on a significant subsidiary, other audit partners, individual responsible for the engagement quality control review.

Regardless of its decisions on other measures intended to address the familiarity and self-interest threats created by long association with an audit client, the board should review whether its 7+2 position on partner rotation is still appropriate. This would include assessing whether, for example, a shorter period on the engagement team and/or a longer time-out period would strengthen auditor independence, and how such a change would operate in a global code. In order to inform the IESBA's consideration, more detailed information may be helpful about:

- the partner rotation requirements in other jurisdictions,
- the types of entities with respect to which partner rotation applies in those jurisdictions (e.g., all public interest entities or other entities according to industry, size, or market characteristics), and
- the definitions of key audit partner and other key terms.

### *Audit Firm Rotation (MFR)*

There is limited experience with MFR in practice. The table below shows the current use of MFR in G20 jurisdictions. A few other smaller jurisdictions have an MFR requirement and two G20 jurisdictions introduced and then repealed MFR; these are noted after the table.

<b>Jurisdiction</b>	<b>Mandatory Firm Rotation</b>
Argentina	No
Australia	No
Brazil	For listed companies, not banks
Canada	No
China	For State owned entities and financial enterprises
France	No
Germany	No
India	For banks, insurance companies, provident trust funds and public sector entities
Indonesia	Yes
Italy	Yes
Japan	No
Mexico	No
Russia	No
Saudi Arabia	All listed companies except banks
South Africa	No
Korea	No
Turkey	Yes
United Kingdom	No
United States	No

Nine smaller jurisdictions have been identified that require MFR. (Laos, Morocco, Oman, Paraguay, Portugal (on a comply-or-explain basis), Qatar, Serbia, Tunisia, Uzbekistan). Some other jurisdictions require MFR for some entities. It is unclear which of these jurisdictions adopted MFR as a means of increasing competition in the audit markets and which did so because they believed it would strengthen the auditor's independence.

Ten jurisdictions have introduced and then repealed or partially repealed MFR. Those in the G20 are Brazil (partial repeal) and Canada.

There is extensive academic literature on MFR, although academics Roush, Church, Jenkins, McCracken and Stanley in a commentary on the PCAOB's concept release<sup>2</sup> said "research that directly examines the effect of mandatory audit firm rotation is scant because, except for a handful of countries, such a regulatory regime has not been implemented." This academic commentary summarizes: "the vast majority of academic findings are not supportive of mandatory

<sup>2</sup> <http://aaapubs.org/doi/pdf/10.2308/ciia-50100>

audit firm rotation (e.g., Cameran et al. 2005; Stefaniak et al. 2009)<sup>3</sup> The two sources quoted are both academic literature reviews.

Based on research to date, covering academic studies, government studies, comments made at the PCAOB public roundtable meetings, and comment letters to the EC and PCAOB, observers have made a number of arguments for and against MFR. On balance, there are more arguments opposing MFR than supporting it. The next few pages summarize many of the key arguments.

*The arguments in favor of MFR include:*

1. Mandatory audit firm rotation is the most effective means of addressing the familiarity and self-interest threats.

The Code cites familiarity and self-interest as a threat to independence. The EC Green Paper states “Situations where a company has appointed the same audit firm for decades seem incompatible with desirable standards of independence.” This reflects the familiarity threat. However, familiarity is also cited as increasing audit quality (see arguments against MFR below).

The Code definition of independence includes “independence in appearance.” Both the EC Green Paper and the PCAOB concept release raise questions about independence in appearance when an entity retains the same audit firm for many years.

In the US, according to research firm Audit Analytics, as quoted on the National Association of Corporate Directors (USA) website, nearly 175 companies in the S&P 500 have had the same audit firm for 25 years or more, 16.1 percent of the Russell 1000 have engaged the same audit firm for 40 years or more, and eight companies in this group have not changed auditors for the last century<sup>4</sup>. A report from the GAO in 2003 provided the following:<sup>5</sup>



<sup>3</sup> <http://aaapubs.org/doi/pdf/10.2308/ciia-50100>

<sup>4</sup> <http://www.directorship.com/mandatory-audit-firm-rotation-explaining-the-key-numbers/>

<sup>5</sup> <http://www.gao.gov/new.items/d04216.pdf>

Auditors' average tenure in the FTSE 100 is 48 years. According to John Plender, a chartered accountant and FT journalist: "Finally, the tenure of auditors should surely be raised in the stewardship dialogue between investors and management. Auditors' average tenure in the FTSE 100 is 48 years. At Barclays, PwC or its predecessor firms has been in place since 1896. There are costs in changing auditors, but the status quo looks too cosy by half".<sup>6</sup>

Those who support MFR would argue that by strengthening independence in appearance, MFR would strengthen auditor independence.

2. In those countries where MFR is required (Italy, Turkey, Brazil), there appear to be no suggestions that audit quality has suffered.
3. New personnel would bring a fresh approach to the audit that should be beneficial. For example, a new audit firm would be more skeptical because it lacks familiarity with the client and would not want to miss any material risks. It would be more objective because it would not feel any obligation to accept the client's past accounting. It also would have a fresh perspective, which would be helpful in making key judgments that can benefit the audit. The new audit firm would therefore perform a more rigorous audit than the incumbent firm.
4. The regular re-tendering required for mandatory audit firm rotation may lead to reductions in audit fees. Firm rotation and the re-tendering process is consistent with inviting open market competition.

*The arguments against MFR include:*

1. A new audit firm's lack of knowledge of the client creates a higher risk that they will miss something important; this increased risk outweighs any perceived benefits of a fresh look. There is evidence that audit failures are more likely in the early years of an audit appointment (although not specifically in the context of mandatory firm rotation). The complexity of many public interest entities means that it can take a number of years for a new auditor to become sufficiently familiar with the business model, the business risks, and the entity's staff in order to conduct an effective audit.

Research indicates that audit quality problems are more likely to occur in the early years of the auditor-client relationship, which may be explained by a lack of familiarity with the client's affairs. However, the cause of these effects cannot be categorically concluded. Academic research states: "Empirical evidence suggests that audit quality is relatively lower in the initial years of an auditor-client relationship. Specifically, short tenure is positively associated with audit reporting failures (Geiger and Raghunandan 2002), fraudulent financial reporting (Carcello and Nagy 2004), and reduced earnings quality

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<sup>6</sup> <http://www.ft.com/intl/cms/s/0/ed4033ce-7275-11e1-9c23-00144feab49a.html#axzz1v9epPR2U>



(Johnson et al. 2002). A lack of familiarity may have adverse consequences, which could be exacerbated by instituting mandatory audit firm rotation".<sup>7</sup>

Familiarity with the client, while potentially creating a threat to the audit firm's objectivity, increases the audit firm's cumulative knowledge of the business, its staff, the business model, and business risks. Familiarity, therefore, can promote audit quality. Firm rotation would result in the loss of that cumulative knowledge and experience and thus could reduce audit quality.

2. MFR would likely add cost to the financial reporting process for both the audit firm and the company, the latter primarily through the increased time and effort needed to engage in the proposal process and subsequently to educate the new auditor about the business, its systems, processes, controls, etc. This would divert company personnel from their core activities. The cost incurred by the audit firm to get up to speed on these matters may be passed on to the company. If that cost is not passed on to the company, then the cost of rotation would be borne by the firm. This also could threaten audit quality if audit fees charged are not commensurate with the audit work to be done.
3. Rotation would pose a threat to audit quality for multi-jurisdictional, complex companies. MFR could also be particularly difficult for multinational groups to implement if different jurisdictions have different MFR rules, if multinationals have complex rotations, and if changes in auditors come at inopportune times.
4. Mandatory firm rotation is thought to be most important for major financial institutions. However, those are likely to be the entities that pose the biggest challenge in relation to implementing rotation and also the biggest risk if there is an adverse effect on audit quality.
5. In Italy, rotation has led to increased market concentration. There is also evidence from Germany that retendering leads to greater market concentration rather than less (although not specifically in the context of mandatory firm rotation).<sup>8</sup>
6. MFR could reduce the ability of audit firms to recruit high-quality audit professionals. For example, in specialized industries there may be a limited number of qualified audit professionals. When a company is forced to switch firms, those professionals may have reduced ability to utilize their industry expertise if the firm is unable to replace the lost clients. Further, audit professionals will be diverted from performing audits, because they will need to spend time on tenders. Firms would likely need dedicated marketing and proposal teams to deal with an increase in proposal opportunities. This would require significant investment, which would divert funds away from investments in audit quality.
7. MFR could raise concerns by the competition and fair trade authorities. While at first glance a rotation requirement sounds like it would increase competition, it could have the

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<sup>7</sup> <http://aaapubs.org/doi/pdf/10.2308/ciia-50100>

<sup>8</sup> <http://www.idw.de/idw/portal/n589244/n593822/n619976/index.jsp>

opposite effect if smaller firms that have worked hard to cultivate an audit relationship with an entity have to rotate off and have difficulty replacing the client with a similar size client. If, as in Italy, where it appears that market concentration has increased and smaller firms have effectively been rotated out of the market, those who would be required to adopt the Code could be prohibited from doing so by competition authorities on grounds that it is anti-competitive.

Although the activities of audit committees fall outside the remit of the IESBA, they are an integral part of the auditor selection process and have an important role in overseeing the auditor and contributing to audit and financial reporting quality. The IESBA may wish to consider the importance of the role of the audit committee, its interaction with the auditor, and the responsibilities of both parties in contributing to audit quality. The right of audit committees to determine the tenure of auditors is an important part of corporate governance, which would be changed by MFR. Opponents of MFR argue that it would preclude audit committees from making a decision to change auditors at a time of their choosing and note that it makes no sense to force an audit committee to change auditors when the current auditor is performing a high-quality audit.

## **Audit Firm Re-tendering**

Audit firm re-retendering was considered briefly in a report by the UK's Co-ordinating Group on Audit and Accounting Issues to the UK Government in July 2002. The UK's Financial Reporting Council issued a consultation document in April 2012 under which FTSE 350 companies would be expected to put the audit contract out to tender at least every ten years. Relatively little evidence of the impact of audit firm re-tendering has been found to date.

*The arguments in favor include:*

1. It may reduce the perception of a familiarity threat by potentially increasing the rate of audit firm turnover.
2. It breaks the assumption that the current auditor will automatically be re-appointed and encourages the audit committee to assess auditor performance. It would thus promote audit committees making judgments about the balance of risk between familiarity and inexperience and demonstrating that they are exercising their responsibilities for audit appointments.
3. If retendering increases competition, it may stimulate the addition of new personnel and development of new audit techniques and lead to a reduction in audit fees.
4. It may avoid the competition concerns implicit in firm rotation and may increase competition in the audit market.

*The arguments against include:*

1. Compulsory re-tendering could encourage an expectation that in the absence of exceptional circumstances, an evaluation of the auditor's performance need not occur until the next mandatory tender.
2. Re-tendering takes time and money. It is not clear if these burdens would be offset by any additional material benefits to audit quality. In that case the costs are a disincentive to change, particularly if they result in audit firms diverting investment funds away from audit quality initiatives in favor of marketing and proposal activities.
3. It may lead to increased market concentration.
4. If used as a tool to reduce audit fees, there is a risk that audit quality would be sacrificed in order to meet the lower fee requirement. Continual reductions in audit fees could make it more difficult for the audit profession to attract talented professionals to the audit practice.
5. While the audit firm may be motivated to perform a high-quality audit in the year preceding the retendering, it is unclear what effect, if any, retendering would have on the audit firm's motivation to perform a high-quality audit in any of the years prior to that.

## **Impact Analysis**

The IESBA considers the impact of its proposals. The lack of conclusive evidence for MFR would make an impact analysis challenging. However, given that the Code is a global code, were the IESBA to support MFR, an impact analysis would need to consider the global impact of the proposal, beyond the EU and US, and possibly beyond PIEs. The impact analysis would need to consider factors such as the likely cost and the impact on audit quality, audit committees, market concentration, and the profession's ability to attract and retain talent. And, it should consider the operability of such a requirement in a global code.

Although the audit market is outside the remit of IESBA the introduction of MFR is likely to have an impact on the audit market. It is understood that the introduction of MFR in Italy was intended to address market concentration but according to the Bocconi study: "The findings support the idea that mandatory rotation leads to higher market concentration in the larger client segment because there is a high probability that a large size listed company will appoint as auditor one of the Big 5 firms".<sup>9</sup> This is supported by Stephen Haddrill, Chief Executive of the UK's Financial reporting Council in May 2011: "We also believe that mandatory rotation of audit firms could increase rather than reduce concentration in the market given the risk that companies drop smaller audit partnerships when they retender"<sup>10</sup>.

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<sup>9</sup> Cameran, Mara, Merlotti, Emilia and Di Vincenzo, Dino, The Audit Firm Rotation Rule: A Review of the Literature (September 1, 2005). SDA Bocconi Research Paper. Available at SSRN: <http://ssrn.com/abstract=825404> or <http://dx.doi.org/10.2139/ssrn.825404>

<sup>10</sup> <http://www.frc.org.uk/images/uploaded/documents/Speech%20by%20Stephen%20Haddrill%20on%20Auditing%2020%20May%202011.pdf>

The IESBA could also investigate the impact of MFR in jurisdictions that have introduced MFR, including those that have continued to use it and those that have discontinued it.

## Conclusions

1. The Code's 7+2 position on partner rotation deserves reconsideration.
2. The evidence for MFR is inconclusive. Accordingly, judgment will be required in determining the Board's position.
3. Same as 2 regarding re-tendering. Since little evidence of the impact of re-tendering has been found to date, this may merit further research.

### Action requested

The Board is asked if it wishes to review the current requirements set out in the Code on partner rotation with a view to updating them.

The Board is asked if it wishes to carry out further research on mandatory audit firm rotation and re-tendering to enable it to explore these safeguards as a way of addressing the familiarity and self-interest threats due to long association with an audit client.

## Material Presented

Agenda Paper	This Agenda Paper
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