AUDITOR ROTATION IN AMERICA

No Love Lost

By Ramona Dzinkowski

Does it matter that the largest U.S. companies (based on market capitalization) keep their same auditor for an average of 20 years—or in some cases much longer? The U.S. Public Company Accounting Oversight Board (PCAOB) thinks it does, and it has been proposing to do something about it. Meetings continue over whether mandatory audit rotation, which the PCAOB endorses, is the best way to ensure independence and remove skepticism.

Since the early 1970s, auditor rotation has been the subject of some debate in America and elsewhere around the world. With the recent financial market crises, the topic has again reached the public policy domain with the PCAOB's "Concept Release on Auditor Independence and Audit Firm Rotation," dated August 16, 2011. (In December 2011, the European Commission (EC) proposed similar sweeping reforms of the audit market, which I'll touch on later.) According to PCAOB Chairman James Doty, the main reason to consider auditor term limits is that "they may reduce the pressure auditors face to develop and protect long-term client relationships to the detriment of investors and our capital markets." More specifically, "By ending a firm's ability to turn each new engagement into a long-term income stream, mandatory firm rotation could fundamentally change the firm's relationship with its audit client and might, as a result, significantly enhance the auditor's ability to serve as an independent gatekeeper."

A Call for Feedback

In the concept release, the PCAOB, while indicating that improvements in the rigor of inspections and the remediation process have improved audits, expressed concerns about both the frequency and the types of audit deficiencies it uncovers. In particular, in its inspections of the largest accounting firms from 2004 through 2007, it notes: "Inspectors continue to find deficiencies in important audit areas, both established and emerging. These areas include critical and high-risk parts of audits, such as revenue, fair value, management's estimates, and the determination of materiality and audit scope." These deficiencies occurred in audits of issuers of all sizes, including in some of the larger audits they reviewed. In some cases, the deficiencies appeared to have been caused, at least in part, by the failure to apply an appropriate level of professional skepticism when conducting audit procedures and evaluating audit results. In addition, even in areas where inspectors have observed general improvement, deficiencies continue to arise, the PCAOB reports.

With this in mind, the concept release focused on the role of mandatory auditor rotation in improving independence and objectivity in audits and asked for feedback on the following key issues, among many others:

- Will mandatory auditor rotation significantly enhance auditors' objectivity, professional skepticism, and ability and willingness to resist management pressure?
- What effect would a rotation requirement have on audit costs?

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- Would a periodic "fresh look" at a company's financial statements enhance auditor independence and protect investors?
- If the PCAOB decided to move forward with the development of a rotation proposal, what would be an appropriate term?
- To what extent would a rotation requirement limit a company's choice of an auditor?

The Nays Have It

Public comments on the issue of mandatory audit rotation showed that the majority of corporate executives were decidedly against it, and other stakeholders were downright irate. (Those in favor include, most notably, past chairs of the Securities & Exchange Commission (SEC).)

As for corporate America, they suggest that in today's complex business and regulatory environment a deep level of knowledge around a company and its industry, operations, and financial history is mandatory in conducting an effective audit, which calls into question the wisdom of shortening audit engagements. Under these circumstances, mandatory auditor rotation will therefore result in *less effective audits*, not the other way around. For example, Douglas Muir, CFO of Krispy Kreme Doughnut Corporation, says, "Forced rotations may remove valuable institutional knowledge from the audit process precisely when the audit committee believes that such expertise is necessary for the protection of investors and other users of financial statements."

Also, at a time when the U.S. economy is still working to regain its footing, cost management remains a significant concern to most companies. For those who are charged with allocating resources across the firm, the biggest concern is the potential for mandatory auditor rotation to significantly increase audit fees and related expenses and divert management teams to educate new auditors. As Scott Kuechle, executive vice president and CFO of Goodrich Corporation, explains, "The cost of the audit would most likely increase significantly as more audit hours would be required to learn the accounting processes at the new client. Likewise, the cost of client support would also increase to support the auditors." Therefore, he concludes, "We do not believe that the benefit of mandatory auditor rotation would exceed the cost." Similarly, Arnold Hanish, chief accounting officer of pharmaceutical giant Eli Lilly, points out the added administrative burden, noting, "This would include time spent by upper management and the audit committee preparing invitations for bids, providing information to bidders, and evaluating and interviewing bidders in order to make a selection." In addition, Hanish says, "Substantial amounts of senior management time on both the client and auditor side would be spent revisiting significant accounting decisions that were previously vetted."

The Auditors Weigh In

And what do the auditors have to say about mandatory rotation if, in fact, there's an opportunity to increase revenue from it? This time, the auditors seem to be decidedly in agreement with corporate America. More specifically, Deloitte & Touche doesn't think auditor rotation will cut it when it comes to "increasing auditor independence, objectivity, and professional skepticism." CEO Joe Echevarria, commenting on behalf of Deloitte, concludes the following based on "an objective assessment of the literature on mandatory rotation":

- Research studies show that restatements and frauds are less likely to occur with longer auditor tenure.
- The majority of published studies on mandatory rotation reach an unfavorable conclusion on the balance between costs and benefits.
- If mandatory rotation were required at the 500 largest U.S. companies, a 10-year phase-in process would entail 50 auditor changes every year compared to the recent average rate of five per year.
- The economies and capital markets of countries that have adopted mandatory rotation aren't directly comparable to those of the United States. Some countries that have adopted the policy have discontinued or curtailed it.

As to the need for the PCAOB to explore additional rules around auditor independence, others suggest that Sarbanes-Oxley has actually covered it quite nicely. "The rules put in place by the Sarbanes-Oxley Act charge the audit committee with the selection and oversight of the audit firm," notes Robert C. Greving, chairman of the Audit and Enterprise Risk Committee of CNO Financial Group, a $32 billion holding company with insurance subsidiaries throughout the U.S. "We believe the audit committee is in the best position to evaluate whether the auditors are independent and objective and whether it's in the best interests of the shareholders to initiate the process of selecting a new firm."

Missing the Point?

At the end of the day, would shorter engagements have prevented some of the reporting and assurance catastrophes of the last two decades? Eli Lilly's Arnold Hanish doesn't think so. "We're not aware of any relevant data or evidence linking lengthy audit firm tenure to audit failures," he says, adding that the sample of audits that the PCAOB inspects "is not a representative sample, as the Board focuses on the most error-prone situations." Hanish suggests that, in place of mandatory rotation, the PCAOB consider further limiting the scope of nonaudit services that the audit firm can provide to its clients, potentially limiting all advisory services. "We believe," he explains, "that action in this area may address the PCAOB's concern that the auditors are attempting to maintain good client relationships at the expense of performing a quality audit in order to engage in more lines of business and provide additional services to the company."

Other observers, like Richard Hawley, CFO of Nicor Inc., go further, suggesting that audit rotation answers nothing. Having been on all sides of the issue (as an audit partner, a *Fortune* 500 and 1,000 CFO, and chair of a public company audit committee), Hawley considers mandatory rotation of audit firms "a wonderful theoretical solution looking for a nonexistent problem." Furthermore, he questions the need for yet more government intervention in corporate business. "My issues with the proposal are many," he says. "First, it presumes the company boards and management . . . are not capable of selecting firms that will live up to professional standards and are in need of government assistance in making a change when necessary. I don't believe there's any significant evidence to suggest that is the case."

A Matter for Congress?

American lawmakers tend to agree. In fact, two motions were put on the table: one that could make auditor rotation for some companies a moot point, and the other coming down hard on the PCAOB, effectively silencing it on the topic. First, the Jumpstart Our Business Startups (JOBS) Act, which President Obama signed into law on April 5, 2012, provides for exemptions to any auditor rotation rule that might come into effect. More specifically, the Act loosens many of the existing regulations and laws with respect to initial public offerings, and states that IPO companies with up to $1 billion in annual revenue (which the Act also calls "emerging growth companies") are exempt from any future PCAOB rules mandating auditor rotation or making modifications to the auditor report. These companies are also exempt from the auditor attestation requirements of Section 404(b) of SOX. These exemptions remain in force for up to five years after the date of the IPO.

Meanwhile, a draft bill has been introduced in Congress by Rep. Michael Fitzpatrick (R.-Pa.) that, if passed, would effectively remove the PCAOB's authority granted to it through SOX legislation to deal with the auditor "term limits" issue. For some, this somewhat extreme response to the PCAOB's concept paper—which by the Board's own admission was an investigative process to better understand the issues surrounding auditor rotation—is more than a little suspect. Recent *Wall Street Journal* coverage suggests that Congress's new fervor for weighing in on accounting/auditing regulation reflects interest-group pressure from the U.S. Chamber of Commerce and the Big 4 and points to certain campaign contributions made to Rep. Fitzpatrick by PwC during 2011.

Globalization of the Audit—One World

Finally, the PCAOB concept release hasn't gone unnoticed by the international community, which reminds the Board that auditor rotation in America isn't just a U.S. issue. According to the Japanese Institute of Certified Public Accountants, a U.S.-based rule will have implications for U.S. multinationals everywhere. In its written comments to the Board, the JICPA said, "For example, if an entity belongs to [a] large group, components within the group may obtain various nonaudit services, and therefore, the choice of the auditor for the entity may be significantly limited." The JICPA added that local country audit rules may conflict with U.S. law: "If a regulator in each jurisdiction implements such radical and uniform measurement respectively, there may be cases where a multinational entity may not have a choice of an auditor."

The Federation of European Accountants also points to the need for one globally coordinated audit rule. It strongly encourages the PCAOB "to coordinate any initiatives with its counterparts in Europe and in other parts of the world, such as in Asia, in order to achieve a coherent, practical and sustainable solution." In taking the lead on this issue, in December 2011 the European Commission proposed sweeping reforms of the audit market:

- Audit firms will be required to rotate after a maximum engagement period of six years (with some exceptions).
- The period before which rotation is obligatory can be extended to nine years if joint audits are performed: in other words, if the entity being audited appoints more than one audit firm to carry out its audit, thus potentially improving audit quality by applying the "four-eyes principle."
- A cooling-off period of four years applies before the audit firm can be engaged again by the same client.
- Audit firms will be prohibited from providing nonaudit services to their audit clients.

The comment period for the PCAOB's concept release was reopened (for the second time) and extended until July 28, 2012. A second public meeting concluded at the end of June; complete audio and video are available at www.pcaob.org. The PCAOB is now in deliberations on what the next steps will be toward limiting the length of auditor engagement for U.S. firms, if at all. **SF**

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