PRACTICE NOTES

Mandatory audit firm rotation

November 2013

Mandatory audit firm rotation

All blue text in this practice note is extracted directly from the Global Network of Director Institutes (GNDI) Mandatory Audit Firm Rotation: GNDI Perspective[1] document issued in May 2013, which has been reproduced with the permission of the GNDI.

Purpose

The purpose of this practice note is to provide the King Committee's view on mandatory audit firm rotation (MAFR) as a mechanism to achieve auditor independence.

Introduction

Independently audited financial statements are critical to capital markets. While some companies can survive on earnings alone, most need the additional cash flow from debt or equity sources—and these sources need audited financial statements to lend or invest with confidence. Without having reliable audits from independent audit professionals, many companies could find it difficult or even impossible to attract the external capital they need.

All developed economies today require independent audits of publicly held companies' financial statements, and the audit firms that perform these adhere to a myriad of standards for independence. Yet year after year and decade after decade, some companies that have received clean audits experience unforeseen financial crises. And at those times, rightly or wrongly, the attention of the media, investors, and regulators focuses on auditor independence—sometimes pointing to the long tenure that many larger audit firms have had with their clients. With some auditors serving particular companies for as long as a half century, how can these firms be truly independent, some ask. It is important to acknowledge that an audit provides reasonable and not absolute assurance on the financial statements of a company with respect to fraud and error. An audit does not provide a guarantee as to the future sustainability of a company[2].

In light of the long tenure of auditors of some companies, one concept that continually resurfaces in public debates on auditor independence is the notion of MAFR. In some cases, the topic is moving from discussion to rulemaking. From time to time, in response to financial crises, some countries have passed rules for limiting duration of audit engagements, with limits generally ranging from 5 to 10 years. Other countries have avoided passing absolute mandates, but have proposed or implemented alternative means to achieve greater auditor independence. In recent times, in the long tail of recession following the financial crisis of 2008, the issue was revived in many countries as they seek to move toward or away from MAFR.

In light of the renewed interest in MAFR, the King Committee has reviewed current trends. Overall, it seems that the once-vigorous move toward more MAFR mandates seems to have slowed and even reversed. Some countries that enacted early mandates have softened them in recent years. Meanwhile, in countries or regions where a MAFR rule is pending, there is considerable opposition that appears to be preventing MAFR from becoming the law of the land. Yet this issue is far from settled at this time, as any new financial crisis may revive the topic again.

[1] http://www.gndi.org

[2] International Standard on Auditing 200 Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing. See paragraph 3, 5 and A1.

The South African legal and regulatory context
(Refer to Annexure 1 for Key Global MAFR Developments)

The notion of auditor independence is entrenched in South African law. Whilst MAFR mandates do not exist in South Africa, alternative means to achieve auditor independence have been implemented in South African law, including

1. The appointment of the auditor by the shareholders
   Section 90[4] of the Companies Act, 2008 (the Act) requires the shareholders of a public or state-owned company to appoint an auditor at each Annual General Meeting. This is considered a strong protection as it limits the ability of the board or management to make choices to retain auditors to protect their interests.

2. The statutorily appointed audit committees' duties regarding the oversight of auditor independence
   The Act requires in section 94(7)(a), that the statutorily appointed audit committee must nominate, for appointment as auditor of the company under section 90, a registered auditor who, in the opinion of the audit committee, is independent of the company. Section 94(7)(f) further requires the audit committee to prepare a report to the shareholders, to be included in the annual financial statements for that financial year stating whether the audit committee is satisfied that the auditor was independent of the company.

   Section 94(8) provides guidance on what to consider in respect of auditor independence, including:
   (a) Ascertain that the auditor does not receive any direct or indirect remuneration or other benefit from the company, except-
      (i) As auditor, or
      (ii) For rendering other services to the company, to the extent permitted
   (b) Consider whether the auditor's independence may have been prejudiced-
      (i) As a result of any previous appointment as auditor; or
      (ii) Having regard to the extent of any consultancy, advisory or other work undertaken by the auditor for the company; and
   (c) Consider compliance with other criteria relating to independence or conflict of interest as prescribed by the Independent Regulatory Board for Auditors[3] established by the Auditing Profession Act,
   in relation to the company, and if the company is a member of a group of companies, any other company within that group.

   Section 94(9) of the Act states that whilst nothing precludes the appointment by a public company at its Annual General Meeting of an auditor other than one nominated by the audit committee, if such an auditor is appointed, the appointment is valid only if the audit committee is satisfied that the proposed auditor is independent of the company.

3. Audit partner rotation
   Section 92[4] of the Act provides for audit partner rotation, more specifically that "an individual may not serve as an auditor or designated auditor of a company for more than 5 consecutive financial years". If an individual has been an auditor or designated auditor of a company for 2 or more consecutive years, and then ceases to be an auditor, the individual may not be appointed again until after the expiry of at least a further 2 financial years.

3 http://www.irba.co.za/
4 Sections 90 and 92 apply to:
- public companies;
- state-owned companies (except to the extent that the company has been exempted in terms of Section 9 of the Act);
- private companies, personal liability companies and non-profit companies if required by the Act or the regulations to have their annual financial statements audited; and
- private companies, personal liability companies and non-profit companies that voluntarily elect to have their annual financial statements audited to the extent that the company's Memorandum of Incorporation so requires.

King III[5] has similar requirements in relation to auditor independence. Specifically, principle 3.9, paragraph 77 states that "*The audit committee must review, monitor and report on the external auditor's independence and objectivity and should assess the effectiveness of the audit process every year. At least five yearly, rotation at an individual engagement partner or designated partner level enhances actual and perceived independence*".

Another mechanism to address auditor independence as contained in King III, is principle 3.9, paragraph 75 which states that "*The audit committee must recommend to shareholders the appointment, reappointment and removal of the external auditor. Where the audit committee recommends to shareholders that the incumbent auditing firm and designated auditor (a statutory responsibility for public companies and state-owned companies in terms of the Act) should be appointed as the external auditor, its recommendation should be based on an assessment of the auditing firm and the individuals' qualifications, expertise and resources, effectiveness and independence*."

Further mechanisms to achieve auditor independence in South Africa are included in the SAICA[6] (South African Institute of Chartered Accountants) and IRBA[7] (Independent Regulatory Board for Auditors) codes of professional conduct which require audit partner rotation. In addition, an auditor is required to be independent and where there are threats to their independence, they are required to implement measures to reduce the threats to an acceptable level. If this is not possible, the auditor is prohibited from accepting the engagement that would compromise their independence.

The pros and cons of MAFR

Proponents of MAFR suggest the following benefits:

- The primary potential benefit of MAFR is to achieve a greater degree of auditor objectivity and independence by reducing the risk of auditors becoming overly familiar with a company's management and losing their professional scepticism.
- MAFR may also reduce the risk that commercial pressure to maintain a long-term economic relationship with a particular company could undermine an audit firm's commitment to the rigour and independence of the audit process.
- Another common rationale for MAFR is that a new audit firm will conduct the audit with fresh eyes and may be more likely to identify/detect issues than a long-standing audit firm. In addition, is it felt that the knowledge that another firm will soon review the current auditor's work could reinforce the professional scepticism of the existing auditor.
- Some suggest that MAFR could eradicate the oligopoly created by the big 4 audit firms and thereby reduce the effect that the exit of one of these firms will have on the financial market.
- Some believe that MAFR might also afford the smaller firms an opportunity to enter the markets that are currently only serviced by the larger audit firms.

[5] The King Report on Governance for South Africa - http://www.iodsa.co.za/?page=kingIII

[6] https://www.saica.co.za/Technical/Discipline/CodeofProfessionalConduct/tabid/701/language/en-ZA/Default.aspx

[7] http://www.google.co.za/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=3&sqi=2&ved=0CDcQFjAC&url=http%3A%2F%2Fwww.irba.co.za%2Findex.php%2Fcomponent%2Fdocman%2Fdoc_download%2F671-code-of-professional-conduct&ei=2pVfUu2EEIGThQfuroG4BQ&usg=AFQjCNFzZ6ywOcqvGhdcdHxcBcKYdkVb0w&sig2=M-W08s4asjymQno8jDET8g&bvm=bv.54176721,d.ZG4

The following concerns around MAFR are raised:

- MAFR would result in losing the cumulative audit knowledge gained over the years at arbitrary intervals.
- MAFR could increase 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 audit quality – this should not be equated with over-familiarity with management.
- MAFR would increase the amount of time management spends during a transition on educating the new auditors on the company's operations, systems, business practices and financial reporting processes. Shareholders indirectly bear those costs.
- A regulatory time frame that sets out when MAFR should occur does not provide the flexibility to enable companies to defer an MAFR when it is at an inopportune time (e.g. during a major transaction) and is not in the best interests of the company's shareholders.
- MAFR may reduce the ability of audit firms to accumulate the required sector/ industry expertise and impact on the ability of audit firms in attracting and retaining talent in specialised industries or remote locations.
- MAFR may increase the complexity and attendant ongoing costs of audit compliance within global companies as there may be differing audit rotation requirements in various jurisdictions. MAFR would reduce the accountability and responsibility of the audit committee for periodically assessing the performance of the auditor and, based on that assessment, for determining if and when to require a rotation or tendering of the audit.
- MAFR would also eliminate the right and ability of shareholders from determining who their auditors should be and when it is necessary to change their auditors.
- The imposition of mandatory time limits that restrict a company's choice of auditor is an artificial impediment to the free deliberation of the board or its audit committee.
- Some believe that MAFR actually reduces competition and restricts market forces. Not only can the incumbent firm not bid to audit the client, but the "Review of the EC Impact Assessment" by Copenhagen Economics[8] concluded that MAFR may actually weaken competition as companies gravitate towards a large firm upon rotation, ultimately increasing concentration rather than reducing it.

A view from the ACF

The IoDSA's Audit Committee Forum (ACF) states in an alert on Audit Reform[9] that proposals for MAFR contain "*an implicit criticism of the audit committee's ability to determine whether and when to change auditors… It represents a major change with significant cost implications due to both the frequent rotation of audit firms and the tendering requirements noted below. It will constrain the audit committee's and shareholders' choice of audit firm, which could negatively affect audit quality.*

The ACF holds a mixed view with regard to mandatory firm rotation, with the majority of members being against it mainly because it takes away the rights from the audit committee and shareholders to decide who their auditors must be and when it is necessary to change auditors."

8 http://www.google.co.za/url?sa=t&rct=j&q=&esrc=s&frm=1&source=web&cd=2&ved=0CC8QFjAB&url=http%3A%2F%2Fwww.copenhageneconomics.com%2FAdmin%2FPublic%2FDWSDownload.aspx%3FFile%3D%252FFiles%252FFiler%252FIntranet%252FDocuments%252FGenerelle%2Bfiler%252F622-01%2BCE%2BFinal%2Breport%2BReview%2Bof%2BEC%2BImpact%2BAssessment%2Bon%2BAudit%2BMarket%2B01FEB2012.pdf&ei=OGxvUv6PA4LR7AaCsIFQ&usg=AFQjCNFUtrj7hrUX7j8bVwaLi_dQYFD-vw&sig2=xK3kMzHnktBlpzYHonKEqQ&bvm=bv.55123115,d.d2k

9 http://www.acf.co.za/wp-content/uploads/2013/06/ACF-Alert16-2013-06-05.pdf

The King Committee view on MAFR

The King Committee supports the objectives of enhancing the independence, objectivity and professional scepticism of the external auditor, but it does not believe that MAFR is the best approach to achieving this.

Whilst it acknowledges the potential benefits of MAFR as listed above, it believes that these benefits could be achieved through other mechanisms like those discussed under “The South African legal and regulatory context”.

The King Committee agrees with the GNDI in that it believes that the audit committee is best placed, with the experience and intimate knowledge of the company’s business, to determine when the interests of the company would be better served by a change in audit firm.

Annexure 1
Key MAFR Developments around the World

Australia enacted in 2004 an audit partner rotation period that requires the rotation of an audit engagement partner after 5 successive years for listed entities. In July 2012, the Corporations Act, 2001[10] was amended to allow a listed entity to extend the rotation period up to a maximum of 7 years, subject to the approval of the board of directors prior to the end of the 5 year period. The board is required to pass a resolution approving the extension of the audit engagement partner's tenure. The Board is required to state that this would not have an effect on the quality of the audit and would not give rise to a conflict of interest.

Brazil enacted a 5-year firm rotation rule in 1999 and softened it in November 2011. The Brazilian securities exchange commission, the Comissão de Valores Mobiliários (CVM) in CVM Instruction No. 509 (issued November 16, 2011) lengthened the 5-year rule to 10 for companies that have a Statutory Audit Committee (*Comitê de Auditoria Estatutário* - CAE), which aims to control the internal and external auditors. According to CVM Instr. 509/2011, companies that install and maintain the CAE pursuant to the conditions required by said instruction may hire an independent auditor to provide audit services for up to 10 consecutive years.

Canada had a mandatory audit firm rotation policy for banks but ended it in 1991, in favour of a principles-based approach due to its unintended consequences.[11] Canada has mandatory audit partner (not firm) rotation – seven years with a five-year cooling off period. A recent "Enhancing Audit Quality" initiative in Canada strongly recommended against the adoption of MAFR.

Malaysia does not have a law mandating MAFR. This is not included in the Malaysian Code on Corporate Governance issued by the Securities Commission Malaysia in 2012.[12] However, it does have a professional standard for auditors that mandate the rotation of audit partners, similar to standards in New Zealand and the United States of America. Paragraph 290.151 of the bylaws for the Malaysian Institute of Accountants stipulates that for public interest entities, an individual shall not be a key audit partner for more than five 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. The cooling-off period for the purposes of auditor rotation is extended to five years for financial institutions, which recognises the significant learning curve that auditors of financial institutions face. The rotation requirement applies to the auditor but not to the audit firm. This is consistent with both Malaysian and international standards, and also takes into account the high level of concentration of audit firms of financial companies in Malaysia.[13]

New Zealand's Corporate Governance in New Zealand Principles and Guidelines[14] released by the Securities Commission New Zealand sets out the recommendations with respect to auditor rotation. Section 7 on Auditors states in 7.4 that "No issuer's audit should be led by the same audit partner for more than 5 consecutive years (i.e., lead and engagement audit partners should be rotated from the engagement after a maximum of 5 years).This is similar to the U.S. alternative discussed below.

10 Section 324DA Limited term for eligibility to play significant role in audit of a listed company or listed registered scheme.
11 "Spain and Canada reported that they previously had mandatory audit firm rotation requirements. Generally, reasons reported for requiring mandatory audit firm rotation related to auditor independence, audit quality, or increased competition for providing audit services. Reasons for abandoning the requirements for mandatory audit firm rotation related to its lack of cost-effectiveness, cost, and having achieved the objective of increased competition for audit services." Source 'Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation' http://www.gao.gov/assets/250/240737.htmlNovember 21, 2003.
12 http://www.mia.org.my/new/downloads/circularsandresources/circulars/2012/21/MCCG_2012.pdf
13 http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2012/02/21/000333037_20120221232504/Rendered/INDEX/669290WP00PUBL0C00FINAL0V1.10016FEB.txt
14 http://www.fma.govt.nz/media/178375/corporate-governance-handbook.pdf

The United Kingdom published a new provision in its corporate governance code in September 2012[15], which recommends a re-tendering of the audit mandate every 10 years for FTSE 350 companies. UK listing rules require companies to either comply with this rule or to explain why they have not done so – the so called "comply or explain" approach used by large listed companies in the UK. On the basis of this new provision, it is possible for the current auditor to retain the audit mandate if it proves itself to be superior to other bidders in the re-tendering process. This measure is not equivalent to MAFR, but pursues the same objective of seeking to open up the external audit to more competition.
In a recent development, MAFR was not among the measures the UK Competition Commission proposed to promote competition in the statutory audit services market.[16] The Competition Commission proposed mandatory tendering every 5 years for the UK's largest companies, a significant shift from the 10-year retendering period UK Financial Reporting Council (FRC) rules currently require.

Europe (see also United Kingdom) has a mixed history: For the European Union (EU) in general, a November 2011 regulation, still pending as of October 2013, would introduce mandatory rotation of audit firms after a maximum period of 6 years. This period may be, under certain "exceptional circumstances" (not defined) extended to 8 years. Where a public-interest entity has appointed 2 or more statutory auditors or audit firms, the maximum duration of the engagements will be 9 years. Again, on an "exceptional" basis, such duration may be extended to 12 years. It also provides for a cooling-off period before the audit firm is able to carry out the statutory audit of the same entity again. In order to ensure a smooth transition the former auditor is required to transfer a "handover file" with relevant information to the incoming auditor.[17]

Summarising MAFR and related rules for all 27 EU member countries is not practical, especially in light of this pending rule. However, the following highlights may be instructive:

- Austria adopted a 6-year MAFR mandate in 2004.
- Italy adopted a 9-year MAFR mandate in 2003.
- In December 2012, the Netherlands legislature voted to require MAFR rotation every eight years for public interest entities, commencing on 1 January 2016.
- Spain no longer has an MAFR mandate. Previously, it had an MAFR with a maximum audit term of 9 years and mandatory rebidding every 3 years. However, as in the case of Canada, the MAFR had unintended negative consequences.[18] Thus, Spain rescinded this in 1995 in favour of a rule that says by allowing that after the expiration of the initial period (minimum 3 years, maximum 9 years), the same auditor can be re-hired by the shareholders every year. Several years later, in 2002, Spain mandated rotation of the audit team every 7 years.

In a recent development in early October 2013, The European Union edged closer to imposing mandatory rotation on auditors after members states reached an agreement to open talks with the European Parliament. The European Council's Committee of Permanent Representatives is now proposing a 20-year mandatory audit firm rotation for European companies, with a 15-year mandatory rotation for statutory audit of credit institutions and insurance undertakings in case of public tendering.

The United States of America does not currently require auditor rotation. However, over the past 10 years, there has been continuing interest in this topic. When Congress hammered out early versions of the Sarbanes-Oxley Act of 2002, some legislators argued for audit firm rotation. In the end, the law did not mandate MAFR. Instead, it required rotation of lead and review audit partners every 5 years, as well as imposing other changes on the

15 The UK Corporate Governance Code, September 2012, para C.3.7 (http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.aspx)
16 http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/130719_summary_of_provisional_decision_on_remedies.pdf
17 Source http://ec.europa.eu/internal_market/auditing/reform/index_en.htm
18 See Note 4.

practices of auditors and audit committees. In 2003, the General Accountability Office (GAO) studied MAFR and concluded that the time was not right for this approach. The GAO said that the Securities Exchange Commission and the Public Company Accounting Oversight Board (PCAOB) should give further study to evaluate the adequacy of Sarbanes-Oxley measures before implementing MAFR. In August 2011, the PCAOB issued a concept release on Auditor Independence and Audit Firm Rotation[19], with a deadline that was November 19, 2012. During the comment period, the PCAOB received more than 600 comment letters, mostly opposing MAFR. These negative views on MAFR were echoed throughout 2012 as the PCAOB held a series of public hearings around the country on the topic. Meanwhile, in a related development, on August 15, 2012, the PCAOB adopted Auditing Standard No. 16, Communications with Audit Committees, and Amendments to other PCAOB Standards. Some comment letters say that given this standard, MAFR is no longer necessary. Other letters assert that further changes are needed, but most advocates of change recommend voluntary rather than mandated standards.

The most recent development on MAFR in the US was in July 2013, when the House of Representatives approved a bill that prohibits the PCAOB from forcing pubic companies to automatically rotate their auditing firms. This bill will be reported to the Senate for approval. They argued that selecting a company's external auditor should be a decision made by a public company's board of directors and ratified by its shareholders, and not a decision made by a regulator.

19 http://pcaobus.org/rules/rulemaking/docket037/release_2011-006.pdf; http://pcaobus.org/Rules/Rulemaking/Pages/Docket037.aspx, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=825404