ROTATION THREATS PUT AUDIT IN A SPIN

A proposal in the United States to prohibit the accounting regulator from adopting mandatory auditing firm rotation has thrown the controversial issue into the spotlight. George W. Russell reports on the potential repercussions for the profession in Hong Kong, China and globally

Illustrations by Jackal Tam

The Hong Kong accounting profession and regulators have been watching the growing spectre of mandatory auditing firm rotation – compulsorily enforcing a regular change of auditing firms on public companies – with concern.

With China instituting mandatory rotation last year – following in the footsteps of Brazil and the Netherlands – and other major markets such as Australia and India giving it serious thought, the local profession has been weighing the likelihood of the issue cropping up in Hong Kong.

Mandatory rotation has been mooted over the years as a way to both improve audit quality and broaden the competition among auditing firms. Accounting firms and many businesses disagree, citing newly appointed auditors' lack of knowledge of their client companies and the prospect of higher costs.

Both sides' arguments have been widely presented (see "The pros and cons" on page 17) but the profession in both Hong Kong and internationally have largely concluded that mandatory auditing rotation is unlikely to achieve any of its stated aims.

Opponents received a boost in the United States last month when the U.S. House of Representatives passed a bill to prohibit the Public Company Accounting Oversight Board, the country's accounting regulator, from imposing any form of mandatory auditing firm rotation (see "U.S. stakeholders far from united" on page 18).

The U.S. move follows recent events in the European Union, where initial support among government officials for the concept – which picked up after the start of the global financial downturn and the euro currency zone crisis – has been tempered.

An EU plan released in 2011 called for compulsory rotation of auditors every six to 12 years. However, in April, the European Parliament's legal affairs committee endorsed a version that recommends 25-year limits. (Meanwhile, the United Kingdom's Competition Commission decided last month not to pursue mandatory rotation as a reform option.)

The Hong Kong profession is also closely watching China, where since last year all state-owned enterprises have been required to commission an audit tender process every three years, and an auditor cannot serve for more than five years (see "Mainland emerges as rotation laboratory" on page 19).

> **"We do not support mandatory rotation. There is no evidence to believe it enhances quality."**

Adequate safeguards

In Hong Kong, the profession generally opposes any regulation that mandates change of auditing firm upon a client. "We do not support mandatory rotation," says Chris Joy, executive director of the Hong Kong Institute of CPAs. "There is no evidence to believe it enhances quality."

The Big Four tend to agree with the Institute's position, saying studies conducted so far haven't shown that mandatory auditing answers perceived shortcomings.

"Much research has been done on auditing rotation in different countries and jurisdictions and the results are inconclusive and controversial," notes Raymund Chao, Asia-Pacific assurance leader at PricewaterhouseCoopers in Hong Kong and an Institute member.

To be sure, academic investigations have not borne out the benefits of mandatory rotation on audit quality. "Academic research is sceptical about audit rotation," says Paul Gillis, professor of accounting practice at the Guanghua School of Management at Peking University in Beijing. As an example, Gillis cites a 2007 study of former Arthur Andersen clients that were forced to find new firms after the firm's collapse. "It found no improvement in financial reporting," he says.

Gillis adds that no positive conclusions concerning quality improvement can yet be drawn from China's recent adoption of mandatory audit rotation of state-owned enterprises.

Meanwhile, a recent Institute of Chartered Accountants of Scotland report notes how at least one study confirms that clients with short auditor tenures believe that they can more easily persuade their position in case of a disagreement with their auditors.

Auditors are also less likely to issue a going-concern opinion during the initial years of engagement than they are in later years, adds the Scottish report, entitled *What Do We Know About Mandatory Audit Firm Rotation?*

There are concerns that even if there were benefits of mandatory rotation, they would be outweighed by the negative effects. "[Rotation] may have the opposite effect on audit quality because it uproots the auditor's knowledge of the client," says Benny Liu, head of audit at KPMG China in Beijing and an Institute member.

Hong Kong auditors suggest that longer tenures actually enhance quality. "An in-depth understanding of the client's business, industry risks, operations and controls obtained through years of service would allow the auditor to do a better job of focusing on the key risks and raising the appropriate questions, thereby enhancing audit quality," says Chao.

Auditors stress that mandatory rotation puts unnecessary burdens on both auditors and clients, especially as the hardest part of an audit engagement is at the beginning. "Studies indicate most problems arise in the first two years of appointment," says Joy.

Accepting a new audit engagement requires extensive research about the nature and complexity of the company's business, the qualifications and reputation of senior management and board as well as internal analysis of the auditing firm's own expertise.

In the U.S., the PCAOB received hundreds of comment letters from company directors who argued that mandatory auditor rotation would not improve audit quality because auditors at large public companies would face a steep learning curve in the first few years of the job.

"There are concerns that even if there were benefits of mandatory rotation, they would be outweighed by the negative effects."

"In a large company, the new auditor would take a year or two to get up to speed on all the activities and issues relevant to the new audit engagement," Robert C. Pozen, the former chairman of MFS Investment Management and a senior lecturer at Harvard Business School, told the PCAOB.

Enhancing scepticism

Many objections to long audit contracts centre on professional scepticism – an attitude that requires an auditor to keep an open, questioning mind, assume that management is neither honest nor dishonest, and maintain alertness to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

"There are specific professional ethical standards and independence requirements in place for auditors to safeguard auditor independence," Chao says, citing the prohibition of direct financial interests in audit clients and of contingent fee arrangements, restrictions on scope of services, personal relationships and joint business relationships with audit clients.

An existing counter to too-close relationships in many countries, and a boost for the concept of professional scepticism, is partner rotation. "Some believe that long tenure by auditors makes them less sceptical and more willing to accept client representations at face value," notes Gillis. "Some fresh eyes might audit better."

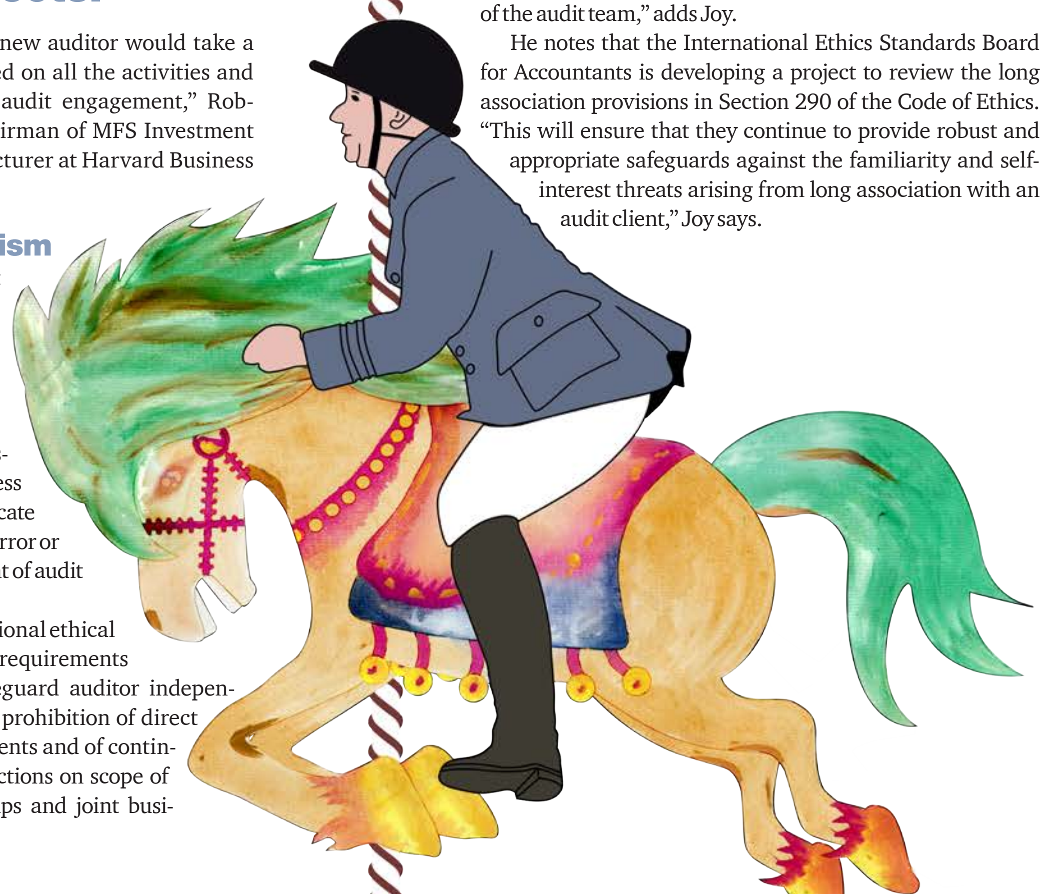
In Hong Kong, key audit partner rotation provisions in the Code of Ethics are in force. The key audit partner in respect of a public interest entity is required to rotate after seven years, and he or she cannot be a member of the engagement team or be the key audit partner for the next two years. This helps to prevent long-term relationships between companies and their auditors creating a level of closeness that impairs auditor independence.

The Hong Kong profession generally supports partner rotation. "New lead and audit partners will bring in fresh perspectives and professional experience," says Liu at KPMG. "However, if you rotate the entire firm, you take away all the accumulated experience the firm has of the client. A lack of knowledge and understanding of the client potentially increases risks of not detecting errors."

However, critics of partner rotation argue that the former audit partner often stays close to the client, even rotating back on the engagement as soon as possible. New lead partners might be reluctant to challenge the work of a colleague, they add.

The Institute believes that partner rotation safeguards are adequate to ensure the integrity of audits in Hong Kong. "Work is going on to extend requirements to more members of the audit team," adds Joy.

He notes that the International Ethics Standards Board for Accountants is developing a project to review the long association provisions in Section 290 of the Code of Ethics. "This will ensure that they continue to provide robust and appropriate safeguards against the familiarity and self-interest threats arising from long association with an audit client," Joy says.



THE PROS AND CONS

Arguments supporting mandatory audit firm rotation
According to a December 2012 report issued by the Institute of Chartered Accountants of Scotland's research committee, entitled *What Do We Know About Mandatory Audit Firm Rotation?*, the main argument in favour of mandatory audit firm rotation is an increase in auditor "independence in fact."

Long tenures by auditors, the argument goes, might lead to excessive familiarity with the client – potentially resulting in insufficient audit procedures and reliance on prior results, the ICAS reporters, led by Corinna Ewelt-Knauer of the Institute of Accounting and Auditing at the University of Münster, noted.

Meanwhile, a March 2013 briefing paper by EY in the United Kingdom – *Q&A on Mandatory Firm Rotation* – cited the "fresh eyes" argument. A newly appointed audit firm would conduct an audit with a new perspective and might be more likely to spot issues than a long-term incumbent firm. In addition, the knowledge that another firm would soon review the current auditor's work could reinforce professional scepticism, the paper noted.

Another argument, the ICAS report noted, is an expected positive effect on auditor "independence in appearance," in which the users of financial statements will perceive the auditor to be more independent as a result of mandatory rotation, reassuring the markets.

A fourth argument is that mandatory rotation can provide smaller audit firms with the opportunity to participate in the audits of larger companies due to increasing market competition.

Arguments opposing mandatory audit firm rotation
According to the ICAS, the first argument against mandatory rotation is that short engagement periods retard the development of an effective working relationship between auditor and client management, and that clients can make their arguments more persuasive against auditors with little familiarity.

The ICAS report cites a second, related, argument against rotation: a higher risk of audit failure, since auditors of short tenure have insufficient time to develop in-depth client-specific knowledge.

In addition, the ICAS report says, rotation could result in a sharp increase in costs – as high as 20 percent by some measures. Newly appointed auditors would be required to understand the client's business model and organizational structure, while client management would have to support new auditors in learning procedures.

Another issue is transparency, says the ICAS report. The market might not be able to distinguish a voluntary change of audit firm from a compulsory rotation, increasing stakeholder uncertainty.

Finally, instead of providing smaller audit firms with more opportunity, it is also possible that mandatory rotation will lead to higher market concentration because large corporations tend to choose one of the Big Four firms, the ICAS report noted.

Crimping competition

In addition to improving audit quality, some proponents have speculated that audit rotation could break the stranglehold on large-company auditing by the Big Four.

However, many observers say that mandatory rotation would cause very little trickle down to non-Big Four firms. "The early evidence is not encouraging," Gillis says, citing the experience so far in China, where mandatory rotation did not result in large companies moving to non-Big Four firms. "What happened was mostly a swap of clients among the Big Four."

Albert Au, chairman of BDO in Hong Kong and a former Institute president, points out that history shows, when forced to change auditing firms, companies tend to rotate out of second-tier firms into the Big Four, but not the other way around.

This has been shown in European countries where mandatory rotation has been imposed, he explains. "It is not theoretical," Au says. "It happened in places like Italy and Germany. BDO Germany had been auditors for Schering, which they lost after 20-something years."

Au adds that he would expect the same situation to develop in Hong Kong under the same circumstances. "If a multinational financial institution or a large Chinese state-owned enterprise is rotated out of one of the Big Four, chances are they won't be engaging BDO, because we are perceived as not being able to service them and their global requirements purely because of their sheer size," he says.

"On the other hand, if one of our largest clients has to move because of mandatory rotation, chances are they will choose a Big Four firm, particularly in Hong Kong, given that we are three times bigger than the [next-largest accounting] firm," he adds. "Filtering down is not on."

The Institute prefers to let the market decide on competitiveness. "Our view is that the concentration of listed company audit work has arisen through market forces and we are not in favour of measures to artificially adjust the market," says Joy.

Rotation, adds Liu at KPMG, necessitates audit partners becoming "salesmen as much as excellent auditors if they are to have long term careers.

"It potentially makes them more reliant on a good reference from their current clients, in order to secure future work, thereby impacting independence," he says.

"New lead and audit partners will bring in fresh perspectives and professional experience."

U.S. STAKEHOLDERS FAR FROM UNITED

Last month, opponents of mandatory auditing firm rotation in the United States hoped to dig the idea a permanent grave. The House of Representatives passed a bill that would, if enacted, prevent the Public Company Accounting Oversight Board, the country's auditing watchdog, from ever forcing public companies to periodically rotate their auditors.

The chamber passed the bill convincingly, with 321 votes in favour and 62 against. The progress of the bill in the U.S. Congress will be watched keenly elsewhere. Indeed, its sponsors said they also hoped the bill would send a strong message to regulators in Europe, who are considering auditor term limits, that mandatory rotation would be unlikely in the U.S.

"Mandatory rotation is unworkable in an industry where firms often have only one or two providers to choose from," Gregory Meeks, a Democratic Party representative from New York and a co-sponsor of the rotation prohibition bill, tells *A Plus*. "Mandatory rotation is costly, and may be very disruptive. Studies conducted in the U.S. showed an increased cost of 20 percent in subsequent years and an additional 17 percent cost for the selection process," he adds.

Meeks says the free market should be allowed to work. "I believe in market competition, and there is currently no law that favours only the Big Four accounting firms," he points out. "Eventually, we may have new auditing firms that emerge and gain the confidence of companies and investors. When that happens, I think that rotation will happen naturally through market forces, not through legislation," he adds.

Maxine Waters, a Democratic representative from Illinois and a senior member of the House finance committee, opened the door for negotiation by sponsoring a successful amendment requiring the Government Accountability Office, the congressional auditor, to study the issue and include a cost-benefit analysis. "I would be open to further debate of this issue if facts and market conditions change significantly," says Meeks.

The American Institute of CPAs opposes mandatory rotation and hopes the recent House vote will clear any doubt. "The PCAOB should pay heed to the recent congressional vote and refrain from any further consideration of a mandatory firm rotation requirement," says Mark Peterson, the AICPA's senior vice-president of governmental and public affairs.

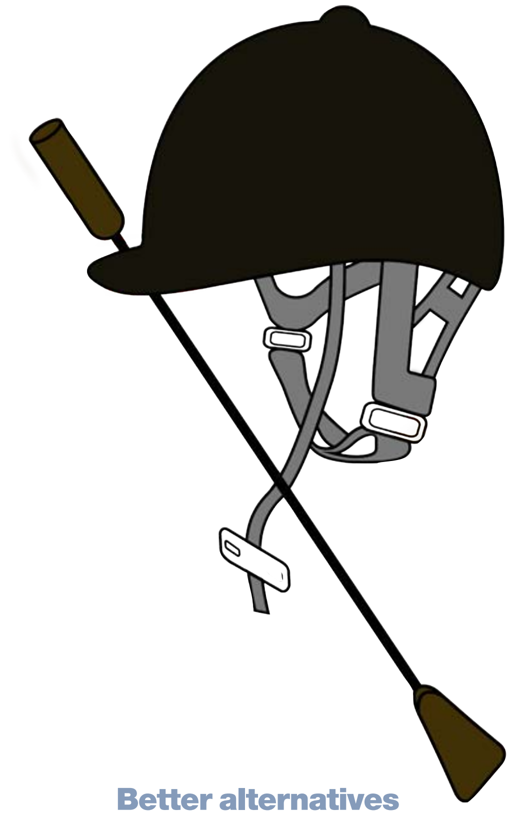
Many senior accounting industry figures agree. "My thought is that a rotation of the audit partner on an engagement would be beneficial [but] I do not think that a change in audit firms is the proper approach," says John Dee, chief operating officer and chief financial officer of Bostrom, a Chicago-based accounting firm that specializes in nonprofit organizations.

However, the U.S. profession is not unanimous. "I personally believe that mandatory rotation is an idea that should be seriously considered, and I am disappointed that the U.S. will not be in the forefront of the movement," says Gaylen R. Hansen, a partner with the EKS&H firm in Denver and chair of the board of the National Association of State Boards of Accountancy.

"There is something that just doesn't feel right when an audit firm has served for over 25 years and in some cases even over 100 years," Hansen adds. "I don't know if there is anything that can replace [mandatory firm rotation] in terms of the impact on professional scepticism."

Despite its easy passage in the U.S. House, the bill is expected to have a much tougher time in the Senate, and even if it passes there, President Barack Obama might well exercise a veto. The final result, say political observers, is likely to be a compromise.

One solution might be a bill to impose mandatory tendering of audit contracts. Whatever the outcome, political strategists in Washington add, accountants are almost certain to face more stringent enforcement and tougher inspections. Hong Kong stakeholders will be watching closely.



Better alternatives

There are other alternatives to mandatory firm rotation to better ensure audit quality, Institute members point out. "A company that has a strong corporate governance structure with an appropriate and effective independent audit committee is best positioned to oversee the audit performance and does not need arbitrary intervals to consider auditor performance and the audit quality," says Chao at PwC.

"Raising the effectiveness of the audit committee's oversight of auditors is one of the best ways to ensure audit quality," says Chao. He adds that an effective audit committee has the best insight into the expertise and quality of the audit firm and whether erosion in expertise and quality warrants the replacement of the firm. He advocates better communications between the auditor and the audit committee and stronger governance by the audit committee.

Chao says company time spent switching auditors could be better used implementing better corporate governance. "Management, audit committees and auditors will need to commit significant time and resources to proposals, diverting their attention away from the more important activities that drive quality reporting and audits," he says.

There is little expectation that audit rotation would be introduced in Hong Kong, even if it crops up in more major international markets. "I expect that there would be great resistance to audit rotation in Hong Kong,

"There is something that just doesn't feel right when an audit firm has served for over 25 years and some cases even over 100 years."

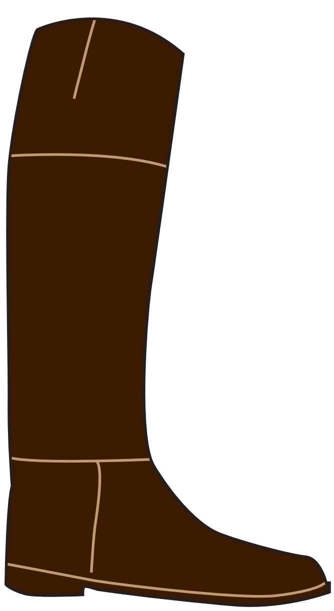
from both the Big Four and from their clients," says Gillis at Peking University.

Hong Kong, Gillis adds, should look to other alternatives that can do a better job of ensuring quality. "Instead of rotation, Hong Kong should put in place a rigorous system of independent audit inspections, similar to those conducted in Canada by the Canadian Public Accountability Board or in the United States by the PCAOB," he suggests.

Joy adds that the Institute, the Hong Kong government and the Financial Reporting Council are collaborating to develop a new regulatory model that would meet international expectations of independence.

In the meantime, Hong Kong stakeholders will be watching the global debate on mandatory rotation with keen interest. While opposing rotation, Big Four firms say they have no issue with policies that widen the auditing field, but warn that it will take time.

"We welcome more competition as it helps to improve standards," says Liu at KPMG. "The challenge for the second-tier firms is developing common culture, values and processes. This requires investment in people, which is time consuming." A



MAINLAND EMERGES AS ROTATION LABORATORY

China's move to mandatory auditing firm rotation last year resulted in few surprises: no second-tier accounting firms won a major contract. While it was suspected in professional circles that Mainland authorities hoped that the rotation would result in some of the big companies moving to China's larger non-Big-Four firms, what resulted was a swap of clients among the Big Four.

"I expect that [smaller accounting firms] will win some next time around," forecasts Paul Gillis, professor of accounting practice at the Guanghua School of Management at Peking University in Beijing. "The government insisted that second-tier firms be included in the bidding process but one firm I talked to said they were not ready for one of the big banks now, but they should be able to build the necessary skills over the next five years."

That might be too late for the next round of rotation. Several large Mainland banks are now due to rotate auditors, with the Bank of China (PricewaterhouseCoopers) and Agricultural Bank of China (Deloitte) accounts expected to change this year. Industrial and Commercial Bank of China (now audited by EY) will be looking for a new auditor in 2014.

Non-Big Four firms are cautious when it comes to declaring that they are ready to audit China's largest institutions. "It all depends on the competency to identify the right working partners in order to strengthen our competitiveness," says Meng Rongfang, senior partner at BDO China in Beijing.

Albert Au, chairman of BDO in Hong Kong and a past president of the Hong Kong Institute of CPAs, says the Mainland is an unusual market in that the government is encouraging development of non-Big Four firms. "The trickle-down effect is not driven by market forces but by government policy."

One area of concern that emerged from the rotation of auditing firms was that those particular auditing contracts dropped in fees. "New audits are harder to do than recurring audits, so the drop in fees means that there will be a drop in audit quality, or partner income, or both," Gillis observes.

Accountants say the price drop is not an entirely unexpected outcome. "Some companies see rotation as a strong bargaining tool to negotiate down their audit fees," says Raymund Chao, Asia-Pacific assurance leader at PwC in Hong Kong and an Institute member.

Chao says continued pressure on fees is undesirable. "If mandatory audit firm rotation results in continual downward pressure on audit fees, this in turn will have significant long term implications for the profession to attract and invest in talent, and to develop the expertise necessary to achieve high quality audits."

Whether higher competition or higher professional scepticism – or both – was the ultimate goal is unclear, but some Mainland auditors show little anxiety over mandatory firm rotation.

"In general, mandatory audit rotation can improve the audit quality," says Meng at BDO. "The rotation of personnel has a positive effect on independence and could also improve audit quality." However, whether the perceived benefits are actually taking place have yet to be proved.