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Auditor Rotation – Is It Time?

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For boards and their audit committees, the question "Is it time to change our external audit firm?" seems to be an evergreen conundrum.

The question could be prompted by the circumstances of the company, or simply heightened awareness by one or more board members of the heavy discussion in the industry and internationally on the subject of mandatory auditor rotation.

The pros and cons of the subject are fairly well known. How a board comes out on the decision on the rotation of auditors depends on how the directors collectively weigh each of the factors.

For rotation

Proponents of rotation believe that it enhances the independence and effectiveness of the external audit.

Rotation, it is argued, helps to avert audit firms from having an excessive focus on maintaining a long-term commercial relationship with the client. Such a relationship could cause the audit firm to be - whether in fact or in perception - too familiar with, or committed or beholden to, the client.

Some of the companies hit by major financial scandals have had long-standing auditors: Enron (16 years), FIFA (16 years), Bernard Madoff Investment Securities (16 years), and Tesco (32 years). Usually after a major accounting scandal, there are fresh calls for greater auditor independence and rotation.

It is also felt that a long-standing auditor could lapse into a state of familiarity, which diminishes its ability to maintain a sharp, objective eye for control weaknesses and changes in the company's circumstances. A periodic change ensures freshness and sharp objectivity that an auditor should bring to the table.

Against rotation

The main argument against rotation is that it can be a time-consuming and disruptive process.

For starters, the selection process involves a significant amount of attention by the audit committee and management, not to mention the audit firms bidding for the work. During the transition period, the company's finance personnel and the incoming auditor must also spend considerable time and resources to orientate the latter to the company's business and controls environment.

The fact is that many companies value the auditor for little else beyond its provision of the bland "true and fair" opinion of the financial statements (at least before the enhanced audit report kicks in next year). And since they believe that most auditors tend to provide that as a matter of course, it seems easier to maintain the status quo.

The limited number of top audit firms also makes it difficult to conduct meaningful rotations for large companies. If only a Big Four firm is being considered, the choices could be limited by the exclusion of the incumbent (which is being rotated out), and others who might be unavailable, be precluded due to conflicts of interest, or just because they are already auditing a major competitor.

Two compromises have thus become popular: rotating the firm's audit partner (rather than the audit firm) and re-tendering without excluding the incumbent from bidding. Both options go some way towards addressing the issues of effectiveness and cost, as well as potentially providing a fresh pair of eyes on the audit. They do not, however, adequately deal with the issue of firm independence.

Where the regulators are

Regulators around the world have long grappled with whether they should mandate rotation. However, the resulting rules remain mixed.

Europe requires mandatory audit firm rotation every ten years for public interest entities, but member states can reduce or extend this period. China imposes a five-year limit for state-owned entities and financial institutions. In India, it is every four years for government companies and financial institutions (and from April 2017, ten years for listed companies and some unlisted companies). In Indonesia and South Korea, it is every six years for listed companies, and in Thailand, it is five years.

At the same time, many countries do not have mandatory audit firm rotation. They include Malaysia, Australia, Hong Kong, Taiwan, Japan and the US.

Whether there is mandatory audit firm rotation or not, there is often mandatory audit partner rotation in most jurisdictions.

In Singapore, locally-incorporated banks previously had to rotate auditors after five years, but this policy was suspended in 2008 due to the global financial crisis. SGX Listing Rule 713 requires that the audit partner in charge must rotate after five years, but may return after a break of two years.

Board direction

Against this inconsistent backdrop, what is the board to do?

It is advisable for the board to have an explicitly articulated policy on auditor rotation. This reduces the frequency of the same debates in the boardroom, and will help respond to the question if raised in a shareholder meeting.

In setting a policy, it is difficult to argue against the systemic risk of keeping the same auditor indefinitely. Hardly anyone would argue keeping the same auditor for, say, 100 years. The question becomes the period with which the board would be comfortable keeping and justifying keeping the same auditor, and what are the other mechanisms (such as partner rotation and re-tendering) it wishes to include.

Either way, these decisions need to be eventually made.

The writer a member of the Governing Council of the Singapore Institute of Directors. This article first appeared in BTInvest, http://www.btinvest.com.sg/specials/boardroom/auditor-rotation-is-it-time/