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Financial Reporting: How 'Mandatory' is Mandatory Auditor Rotation?

Mandatory auditor rotation may bring about a slew of new challenges that could compromise the auditing process and create a more substantial administrative burden for the accounting firm and financial officers of public companies.

By Wayne R. Pinnell

In August 2011, the Public Company Accounting Oversight Board issued a concept release soliciting public comment on ways to improve auditor independence, objectivity and professional skepticism. The comment period, which concludes on Dec. 14, will assess limiting the number of consecutive years for which a registered public accounting firm is permitted to serve as the auditor of a public company.

The concept release is rooted in several core concerns surrounding the auditing process:

· There continues to be a fundamental conflict of interest when the audit client pays the auditor, particularly during a long-term relationship. The concern stems from a potential level of comfort between the two firms that may compromise the auditor's objectivity over time.

However, the auditing business is categorized as part of the service industry, which requires establishment and cultivation of client/vendor relationships.

· Setting term limits on audit relationships could enable auditors to provide more transparency in the auditing process. According to PCAOB Chairman James R. Doty, "The 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."

Current Sarbanes-Oxley Act of 2002 standards enable the auditing firm to maintain its relationship with the firm under review indefinitely. However, the audit partner and concurring partner are required to rotate off the project every five years. This allows for the rotation of personnel without the need to engage an entirely new accounting firm with new policies, procedures and expertise.

The thought process described in the concept release could result in new standards that would require the public company to change accounting firms at the end of a designated rotation period. The actual length of time for an auditor's tenure with a client is one of the points for which the PCAOB is seeking feedback.

Many measures are currently in place to address the issue of auditor independence, objectivity and professional skepticism. The PCAOB, American Institute of Certified Public Accountants and the U.S. Securities and Exchange Commission, along with each of the individual state CPA licensing bodies have their own formal requirements. Each of these bodies also has a specified set of potential sanctions and penalties to be administered to CPAs and accounting firms that undertake improper auditing practices.

The push for objectivity in auditing standards must always remain a top priority for both public companies and the accounting industry. However, mandatory auditor rotation poses numerous philosophical and practical challenges.

If approved, mandatory auditor rotation may bring about a slew of new challenges that could compromise the auditing process and create a more substantial administrative burden for both the accounting firm and financial officers of public companies.

Areas of Concern
Here are a few areas of concern expected to emerge during the comment period. These issues will be of particular significance to chief financial officers and audit committees of public companies.

• **Time Requirements**. Interviewing and selecting an auditing firm is a time-consuming practice. This process requires public firms to identify possible candidates, prepare and send RFPs, review responses and conduct numerous rounds of face-to-face interviews. Repeating this process every set number of years will have a direct impact on productivity in terms of both hours and material costs.

There will also be a high level of coordination required between the outgoing and incoming auditing firms. Larger public companies are required to maintain communication with their preceding auditing firm for more than two years following the change, setting the stage for additional administrative commitments during the interim period.

In the end, the time and resources expended by both the public company and the auditing firm will place a higher level of demand on the executive team.

• **Education**. Engaging a new auditing firm requires an extensive education and on-boarding process. Many believe the greatest risk of an audit failure occurs within the first one-to-two years of an audit relationship. During this introductory period, auditors work to gain a more comprehensive understanding of the new client's business model, reporting structure and accounting systems.

This often results in up to a year of "upstart" time where both the public company and the auditing firm undergo an intensive educational period.

The accounting and auditing disciplines currently require continuous education and training as new personnel enter the profession, changes in accounting and auditing standards occur and general advances in business and technology unfold at a rapid pace. Audit clients frequently cite their lack of appreciation for "training the new staff" on the engagement with the existing firm in its recurring auditor role. This training period will be exacerbated as it extends to an entirely new engagement team from a new firm on a rotating basis.

• **Audit Inefficiencies**. One of the advantages of a long-term relationship with an auditing firm results from the efficiencies that develop with repetition and familiarity. The process of engaging a new firm may compromise certain efficiencies that developed during the previous relationship. This may result in issues such as elongated audit periods, more billable hours and increased time commitment by the public company under review.

With continued economic pressure to keep audit fees in check, the change in audit firms adds an additional obligation for the new firm to become as efficient as possible within a short period of time. During this transitional phase, the new auditing firm is also at risk of missing important components as it becomes acquainted with the new client, threatening the effectiveness of the audit.

Finally, if a firm is aware that it is in its last year of a project, its level of service may wane, consciously or unconsciously, while replacement firms are under evaluation.

• **Conflicting Judgments**. Mandatory auditor rotation poses the risk that the new firm may not agree with the previous firm's judgments in areas ranging from accounting methodologies to effectiveness of internal control over financial reporting (ICFR). This may include differences in various processes and related documentation, differences in judgments, differences in determining a level of weakness — material weakness (MW), significant deficiencies (SD) and control deficiencies (CD) — and changes in the disclosure landscape.

Specifically, with respect to ICFR, classification of a perceived weakness in control as a MW, SD or CD is a significant judgment based upon the collective experiences of the audit engagement team.

However, experiences and judgment may differ vastly among auditors and firms. As a result, the change in auditor could also bring about a change in judgment, resulting in different views as to the perceived level of strength or weakness of ICFR.

· **Limited Options**. Completing a successful audit requires a comprehensive understanding of the client's business model, industry and market position. But what happens if there are only a select number of firms with the requisite market expertise, yet auditor rotation is mandatory?

For example, a large, international firm may require an auditor that also has a global presence and extensive understanding of the international marketplace. This may immediately limit the field to one of the Big Four. Additionally, many of these large international companies have relationships with multiple accounting firms as a result of Sarbanes-Oxley regulations requiring a separation of audit services from other advisory services.

There are also various companies with a niche industry, but a global reach. For these companies, there may a limited number of accounting firms with experience in their industry that can also cover the geography. Changing from an auditing firm with a core focus on a certain industry to a firm with limited expertise and/or limited reach may compromise the auditing process and create unnecessary challenges.

Finally, auditing firms without the requisite expertise of servicing global enterprises may need to acquire additional resources from international alliances of firms. These relationships will, in effect, require additional coordination and administration and pose the risk of diluting the auditing process due to the various standards that exist around the world. These factors may pose new risks to the quality and efficiency of the audit, particularly in the early stages of the relationship.

Where Are We Headed?

The PCAOB will be reviewing comments during Q1 of 2012 and convening a public roundtable to collect further feedback on mandatory auditor rotation in March 2012. While both the accounting industry and public companies should continuously work together to improve the auditing process, new regulations must ensure that new inefficiencies do not emerge.

While mandatory auditor rotation may improve independence, objectivity and professional skepticism by removing the focus on long-term relationships, the practical implementation of such a requirement poses numerous challenges to the auditing process and threatens to create an unnecessary level of auditor turnover which may have the unintended consequence of actually compromising audit quality. Look for the concerns listed above, and surely several others, to emerge as common themes during the impending debate.

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