IMPROVING AUDITOR INDEPENDENCE IN AUSTRALIA:

IS ‘MANDATORY AUDIT FIRM ROTATION’ THE BEST OPTION?

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*The views and opinions expressed in this paper are those of the author and do not represent the views and opinions of the author’s employer or any affiliated organisation.

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I INTRODUCTION

In the wake of the catastrophic global financial crisis ('*GFC*'), regulators around the world are seeking to understand what went wrong, apportion blame and strengthen regulatory mechanisms. Although the GFC 'was not … foremost an accounting crisis, accounting and audit failures appear to have played a secondary but significant role'.[1] As 'gatekeepers' of financial markets, auditors occupy a position of public trust;[2] however, the Big Four[3] accounting firms failed to highlight the underlying fragility and latent weaknesses in the financial system.[4] The European Commission ('*EC*') states in its Green Paper: *'Audit Policy: Lessons from the Crisis'* ('*Green Paper*'):

> The fact that numerous banks revealed huge losses from 2007 to 2009 on the positions they had held both on and off balance sheet raises not only the question of how auditors could give clean audit reports to their clients … but also about the suitability and adequacy of the current legislative framework.[5]

As a result, not unlike post-Enron, the role of auditors, and in particular, mechanisms for improving *'auditor independence'*, are again under scrutiny by regulators, with the possibility of *'mandatory audit firm rotation'* ('*MAFR*') on the agenda. Some form of MAFR is likely to be introduced into the European Union ('*EU*'), possibly by the end of the year; while the United States ('*US*') Public Company Accounting Oversight Board ('*PCAOB*') and the United Kingdom's ('*UK*') Competition Commission ('*CC*') are also currently considering MAFR. Although, with the recent passage of the Audit Integrity and Job Protection Bill through the US House of Representatives, it seems unlikely that MAFR will be introduced into the US.

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[1] Consumer Federation of America, Submission to Public Company Accounting Oversight Board, *PCAOB Release No. 2011-006, Rulemaking Docket Matter No. 37, Concept Release on Auditor Independence and Audit Firm Rotation*, 14 December 2011, 2.
[2] Australian Securities and Investments Commission, *Audit inspection program report for 2011-12*, Report 317 (2012), 5 ('*ASIC Report 317*').
[3] The 'Big Four' is a reference to the four largest global accounting firms, namely KPMG, PricewaterhouseCoopers, Ernst & Young and Deloitte.
[4] European Commission, 'European Commission Green Paper on Audit Policy – frequently asked questions' (Press Release, MEMO/10/487, 13 October 2010), 1; Wolf, Alex, FDs take auditor rotation in own hands (26 September 2012) CFO Insight <http://www.cfo-insight.com/reporting-forecasting/accounting/cfos-take-auditor-rotation-in-own-hands/>.
[5] European Commission, *Audit Policy: Lessons from the Crisis*, Green Paper (2010), 3 ('*Green Paper*'); see also European Commission, 'European Commission Green Paper on Audit Policy – frequently asked questions', above n 4, 1; The Consumer Federation of America states in its submission to the US Public Company Oversight Board:

> Specifically, there is evidence that in some cases auditors allowed financial institutions to hide risks off-balance sheet even though the company remained exposed to the risks. Similarly, there is evidence that in certain instances auditors signed off on, and may even have helped to design, transactions whose only purpose was to hide from investors (and perhaps regulators) the degree of leverage or other risks the company had taken on.

Consumer Federation of America, above n 1, 2.

In comparison to the US and Europe, Australia faired relatively well through the GFC.[6] However, following the release of the Australian Securities and Investments Commission's ('*ASIC*') latest Audit inspection report,[7] which showed a decline in audit quality,[8] Greg Medcraft, Chairman of ASIC, warned Australian auditors that ASIC will advocate for MAFR if audit quality does not improve.[9] In an article in the Australian Financial Review, Medcraft writes: 'The results disappoint and frustrate me. The audit sector should consider itself on notice. … Audit regulatory reforms are being considered internationally. If we do not see improvement in audit quality, there will inevitably be more focus on the need for reforms in Australia.'[10]

Similar to the US,[11] the *Corporations Act 2001* (Cth) ('*Corporations Act*') [12] requires mandatory audit *partner* rotation;[13] but not mandatory *firm* rotation.[14] MAFR aims to combat the perceived risk that long firm tenure negatively affects an auditor's independence due to '*cosy*' auditor/client relationships and the need to maintain client engagements.[15] However, opponents argue MAFR will (among others) increase costs, reduce audit quality, negatively impact corporate governance and heighten audit failure, due to steep learning

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[6] Glenn Stevens, 'Economic Conditions and Prospects' (Speech delivered to the Economic Society of Australia (Queensland) Business Luncheon, Brisbane, 3 July 2013).

[7] ASIC Report 317, above n 2; Australian Securities and Investments Commission, 'ASIC's audit inspection findings for 2011-12' (Media Release, 12-301MR, 4 December 2012) ('*ASIC Report 317 Media Release*'). In ASIC Report 317, which covers the 18 month period to 30 June 2012, ASIC notes:

> Exercising professional scepticism is a critical part of conducting quality audits. … Our reviews of audit files showed insufficient professional scepticism was applied … We found many instances where auditors:
> (a) Appeared to have been over-reliant on, or readily accepted, the management's explanations and representations without challenging the underlying assumptions, or instead sought out evidence to corroborate the estimations or judgements rather than challenging them;
> (b) Had not explored the evidence available in other parts of the audit file that appeared inconsistent or contradictory; and
> (c) Had not given sufficient consideration to historical outcomes in assessing the reasonableness of the forecasts and assumptions underlying the management's decisions.

ASIC Report 317, above n 2, 13.

[8] According to ASIC:

> The report for the 18 months to 30 June 2012 covered inspections of 20 Australian audit firms and found 18% of the 602 audit areas reviewed did not perform all of the procedures necessary to obtain reasonable assurance that the audited financial report was not materially misstated. The figure for the previous 18 months was 14%.
> While the financial reports audited may not have been materially misstated, the auditor had not obtained reasonable assurance that the financial report as a whole was free of material misstatement.

ASIC Report 317 Media Release, above n 7.

[9] Patrick Durkin and Agnes King, 'ASIC threatens auditors with mandatory rotation', *Australian Financial Review* (online), 5 December 2012 <http://www.afr.com/p/national/professional_services/asic_threatens_auditors_with_mandatory_T08zuuBkSqTtX6GQkelQqI>.

[10] Greg Medcraft, 'Auditors need to lift game', *Australian Financial Review* (online), 18 December 2012 <http://www.afr.com/p/opinion/auditors_need_to_lift_game_dEyLBNgTx81xACXlu61lcN>.

[11] *Sarbanes-Oxley Act of 2002*, Pub L No 107-204, 116 Stat 745 (2002), § 203.

[12] *Corporations Act 2001* (Cth).

[13] Ibid s 324DA(1).

[14] According to Durie:

> The present rules only require rotation of audit partners, and some companies like Lend Lease have taken this to a new level by retaining KPMG as its audit firm since its creation in 1958. Lend Lease Chairman David Crawford used to run KPMG.

John Durie, 'ASIC boss Greg Medcraft to put rotation of audit firms on the agenda', *The Australian* (online), 1 December 2012 <http://www.theaustralian.com.au/business/opinion/asic-boss-greg-medcraft-to-put-rotation-of-audit-firms-on-the-agenda/story-e6frg9io-1226527764818>; John Durie, 'Watchdog gives auditors a wake-up call over reporting standards', *The Australian* (online), 25 February 2013 <http://www.theaustralian.com.au/business/opinion/watchdog-gives-auditors-a-wake-up-call-over-reporting-standards/story-e6frg9io-1226584566735>.

[15] US General Accounting Office, Report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services, *Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation* (2003), (What GAO Found)('*GAO Report*').

curves following rotation.[16] According to Breeden, former US Securities and Exchange Commission ('*SEC*') Chairman:

> Ultimately, rotation would replace one set of somewhat conflicted partners with another set of partners with the exact same issue. One group of people would lose their relationship, while another group would step into their shoes and have the identical potential conflict. Theoretically the new firm would also know it would eventually lose the client, but again it would be 6 or 7 years before they would worry about that rather than keeping the client satisfied. Thus we would have a degree of musical chairs among audit firms, and I really doubt that objectivity levels would rise that much overall.'[17]

This essay will explore MAFR to ascertain whether it would be a useful mechanism for improving auditor independence in Australia. First, it will examine the role of auditors and the importance of audit. Secondly, it will consider the importance of 'auditor independence', including threats to independence. Thirdly, it will provide an overview of the regulatory landscape for auditors in Australia, including a brief history of the reforms introduced by the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth) ('*CLERP 9*') to strengthen auditor independence. Fourthly, it will examine MAFR, canvassing the arguments for and against the proposal. Fifthly, it will consider international proposals to introduce MAFR in Europe, the US and UK. Finally, it will review possible alternatives, arguing in favour of the re-tendering regime on a 'comply or explain' basis introduced into the UK under the UK Corporate Governance Code ('*UK Code*') *('UK Re-tendering Regime').*

II THE ROLE OF AUDITORS

A *The importance of Audits*

Audit is 'the cornerstone of commerce';[18] its importance is enshrined in statute. As former SEC Chairman Breeden explains, unlike other professional service providers, the law mandates auditor appointment:

> Accountants play a unique role as the scorekeepers of the market economy. While companies in the U.S. don't have to employ a law firm, an underwriter, or other types of professionals, federal law requires a publicly traded company to hire an independent accounting firm to perform an annual audit. In addition to this shared

[16] Public Company Accounting Oversight Board, 'PCAOB Rulemaking Docket Matter No. 37 – Concept Release on Auditor Independence and Audit Firm Rotation' (PCAOB Release No. 2011-006, 2011), 2-3 ('*PCAOB Proposal*'); Ernst and Young LLP, Submission to Public Company Accounting Oversight Board, *PCAOB Release No. 2011-006, Rulemaking Docket Matter No. 37, Concept Release on Auditor Independence and Audit Firm Rotation*, 18 November 2011, 2.
[17] Statement to Public Company Accounting Oversight Board, Auditor Independence and Audit Firm Rotation, Washington, 21 March 2012 (Richard C. Breeden), 6.
[18] Durkin, above n 9.

> federal monopoly, more than a hundred million investors in the U.S. depend on audited financial statements to make investment decisions. This imbues accounting firms with a high level of public trust ….[19]

Audit performs three key functions. First, it underpins market confidence, which is essential to the functioning of the modern corporate economy.[20] According to the Panel on Audit Effectiveness:

> Audits improve the reliability of financial statements, make them more credible and increase shareholders' confidence in them. Auditors constitute the principal external check on the integrity of financial statements. As former SEC Commissioner … Wallman has noted, "Without accountants to ensure the quality and integrity of financial information, the markets for capital would be far less efficient, the cost of capital would be far higher, and our standard of living would be lower."[21]

Secondly, audit serves an 'information' function, supporting the provision of accurate and reliable financial information to the capital markets,[22] through the 'verification of manager-prepared financial statements'.[23] The US General Accounting Office ('*GAO*') aptly described auditors as 'the independent link between management and those who rely on the financial statements.'[24] Thirdly, audit performs a 'public watchdog' function. For example, under section 311 of the *Corporations Act*,[25] auditors are required to report certain contraventions of the *Corporations Act* and attempts to undermine the audit to ASIC.[26]

B *The auditor's role*

Notwithstanding the important role of audit in the capital markets, auditors are not responsible for a company's financial performance or for detecting corporate fraud or corruption.[27] Rather, at law, '[t]he auditor's role is essentially one of opining on the historical financial statements.'[28] Unfortunately, the legal reality of the auditor's role does not necessarily correspond to society's expectations. This leads to the 'audit expectations gap' ('*AEG*').[29] When assessing the role played by auditors in corporate collapses, it is

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[19] Evidence to Committee on Financial Services, US House of Representatives, Washington, 13, 20 March 2002, 9 April 2002, 457-458 (Richard C. Breeden); see also GAO Report, above n 15, 10.
[20] ASIC Report 317, above n 2, 5; The Conference Board Commission on Public Trust and Private Enterprise, *Findings and Recommendations: Part 2: Corporate Governance; Part 3: Audit and Accounting* (2003), 2; Stephen Bartholomeusz, 'After Enron: The New Reform Debate' (2002) 25(2) *University of New South Wales Law Journal* 580, 589; see also Joint Standing Committee on Public Accounts and Audit, Parliament of the Commonwealth of Australia, *Review of Independent Auditing by Registered Company Auditors*, Report 391 (2002), 5.
[21] Public Oversight Board, *Panel on Audit Effectiveness Report and Recommendations* (2000), 1-2.
[22] ASIC Report 317, above n 2, 5; Melissa Fogarty and Alison Lansley, 'Sleepers awake! Future directions for auditing in Australia' (2002) 25(2) *University of New South Wales Law Journal* 408, 409.
[23] Sattar A Mansi et al, 'Does Auditor Quality and Tenure Matter to Investors? Evidence from the Bond Market' (2004) 42(4) *Journal of Accounting Research* 755; see also The Treasury, *Australian Auditor Independence Requirements: A Comparative Review* (2006), iii.
[24] GAO Report, above n 15, 11.
[25] *Corporations Act 2001* (Cth) s 311.
[26] Ibid.
[27] Fogarty, above n 22, 409; see also Walter Doralt et al, 'Auditor Independence at the Crossroads – Regulation and Incentives' (2012) 13 *European Business Organization Law Review* 89, 90.
[28] Fogarty, above n 22, 412.
[29] Ibid 409; Dennis describes the 'audit expectations gaps' as follows:

important to bear in mind the AEG. To the extent possible, proposed regulatory reforms should seek to narrow this gap.

III THE IMPORTANCE OF AUDITOR INDEPENDENCE

A *Why is 'auditor independence' important?*

In *United States v Arthur Young* ('*Arthur*'),[30] Burger CJ highlighted the importance of auditor independence:

> By certifying the public records that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[31]

Independence is fundamental to audit and the credibility of the audit report; an audit conducted without 'independence' is essentially meaningless.[32] When an *'unqualified'* audit report is issued in circumstances where a '*qualified*' audit report is required, this is an example of 'audit failure', meaning the financial report contains material misstatements.[33] In a worst case scenario, 'audit failure' paves the way for corporate failure.[34]

There are two forms of independence; independence in *'fact'* or *'mind'* and independence in *'appearance'*. APES 110 - *Code of Ethics for Professional Accountants* defines 'independence' as:

> (a) Independence of mind – the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity, and exercise objectivity and professional scepticism;

> Corporate collapses such as Enron and WorldCom are often followed by a chorus of blame. Auditors are castigated for not having warned shareholders and other interested parties about the precarious financial position of the companies that have failed or for failing to detect frauds that contributed to the collapse. Questions like 'Why did the auditors not warn us that the company was not a going concern?' or 'Why did the auditors not detect fraud?' are asked. It is clear from these questions the auditor was expected to discover going concern problems or the fraud during their audit. The fact that the auditors do not meet these expectations give rise to 'concern' about auditing that is expressed through the 'notion of the "AEG"'.
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> Ian Dennis, 'What Do You Expect? A Reconfiguration of the Audit Expectations Gap' (2010) 14 *International Journal of Auditing* 130, 131.

[30] *United States v Arthur Young*, 465 US 805.
[31] Ibid, 817-818.
[32] Fogarty, above n 22, 427; US Securities and Exchange Commission, *Final Rule: Revision of the Commission's Auditor Independence Requirements* (2001).
[33] Geof Stapledon and Jon Webster, 'Directors Duties and Corporate Governance' (2001) 19 *Company and Securities Law Journal* 472, 473.
[34] Ibid.

(b) Independence in appearance – the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a Firm's …, integrity, objectivity or professional scepticism has been compromised.[35]

The importance of independence in 'fact' *and* 'appearance' is highlighted by Burger CJ in *Arthur*: '[i]t is therefore not enough that financial statements *be* accurate; the public must also *perceive* them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional.'[36]

B *Threats to independence*

Independence is clearly vital to audit and yet, ingrained within the auditor/client relationship are significant independence threats.[37] Ian Mackintosh, ASIC's then Chief Accountant highlights the auditor's predicament:

> [A]t the very centre of this minefield, is the paradox that auditors are expected to reconcile a commercial service provider/client relationship with a watchdog/whistleblowing responsibility. All of the commercial incentives support their service provider/client relationship; and there is very little legislative or other incentive to support their public responsibility role. No one would accept that a regulator could properly function in such circumstances, yet we hold an expectation that auditors will perform as 'contracted regulators' of financial reporting.[38]

If the audit function is operating effectively, an '*unqualified*' audit report will be issued where the company's financial statements appear to comply with accounting standards and give a true and fair view of the company's financial position and performance, while a '*qualified*' audit report will be issued where the auditor takes issue with some part(s) of the financial statement.[39] However, as Stapledon and Webster highlight, an auditor's independence is subject to numerous threats:

> a qualified report is presumably not going to be received well by … management – and the auditor will be aware that implications may result. Implications may include termination of the audit mandate …; termination of engagement of the audit firm in other, possibly lucrative, consulting services; a decrease in the company's

[35] Accounting Professional and Ethical Standards Board, *APES 110 – Code of Ethics for Professional Accountants* (December 2010), s 2.
[36] *United States v Arthur Young*, 465 US 805, 819; see also Public Oversight Board, above n 21, 109.
[37] PCAOB Proposal, above n 16, 4.
[38] Ian Mackintosh, 'Auditors and audit committees – a regulator's view' (Speech delivered to the Centre for Corporate Law and Securities Regulation, Melbourne, 28 May 2002), 3-4. It is interesting to note that in the lead up to the passage of the US *Securities Act of 1933*, 15 USC. 77a-77mm, 48 Stat. 74 (1933) and the *Securities Exchange Act of 1934*, 15 USC. 78a-78kk, 48 Stat. 881 (1934) it was originally contemplated that a government body would be charged with responsibility for auditing the financial statements of SEC registrants, however a senior partner of Haskins & Sells (Colonel Arthur H. Carter) convinced the Senate Committee on Banking and Currency to let private accounting firms perform this function. Had legislative responsibility for audit remained with a government body as originally proposed, the issue of 'independence' would be less pronounced, as the interests of auditors and the investing public would be aligned: Stephen A Zeff, 'How the US Accounting Profession Got Where It Is Today: Part I' (2003) 17(3) *Accounting Horizons* 189, 192.
[39] Stapledon, above n 33, 473.

share price (affecting any audit professionals who hold shares in the company), or reluctance of some other companies to appoint or reappoint that firm as auditor. As a result auditor independence is crucial.[40]

Stapledon and Webster identify a number of threats to independence, including:

(a) provision of non-audit services (‘*NAS*’);[41]

(b) members of the audit team (and their immediate family) owning shares/other financial interests in audit clients;[42]

(c) inclusion of ex-audit partners on the client’s board or audit committee;[43]

(d) overdependence on the audit client for fees;[44]

(e) employment of the audit team’s family members with the client;[45]

(f) management’s ability to influence auditor appointment; and[46]

(g) lengthy auditor tenure.[47]

It is this last independence threat that MAFR seeks to address, namely excessive ‘*cosiness*’ between the auditor/client, arguably leading to lack of challenge and inquiry when undertaking the audit. [48]

IV AUDITOR INDEPENDENCE IN AUSTRALIA

A *Historical overview*

Following the collapse of Enron in the US and HIH Insurance in Australia attention was focused on the role played by auditors in these collapses and the need to ensure greater auditor independence. [49] The US introduced the *Sarbanes-Oxley Act of 2002* (‘*SOX*’);[50] while in Australia the then Minister for Financial Services, the Hon Joe Hockey MP, appointed Professor Ramsay to undertake a review of auditor

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[40] Ibid.

[41] NAS may compromise the audit if the auditor is persuaded to give an unqualified audit opinion to protect a lucrative NAS service income stream, or if the auditor is required to audit such NAS: Ibid.

[42] Holding financial interests in an audit client creates a conflict of interests, which can also compromise the audit. A qualified audit report is likely to impact negatively on the audit client’s share price, which would in turn have a negative impact on the auditor’s personal investment: Ibid.

[43] There is a concern that an auditor will be less likely to scrutinise the financial statements of an audit client, if former partners of the audit firm sit on the board and the audit committee of the client: Ibid; Roger Hussey and George Lan, ‘An Examination of Auditor Independence Issues from the Perspectives of U.K. Finance Directors’ (2001) 32 *Journal of Business Ethics* 169, 171.

[44] An audit can also be compromised when the auditor fears the loss of audit fees and is willing to provide an unqualified audit opinion to ensure the continuation of the audit engagement and consequent fee income: Stapledon, above n 33, 474.

[45] Concern for family member’s employment prospects can also compromise an audit: Ibid.

[46] There is a concern that where management has the power to significantly influence auditor retention, an auditor may be less likely to issue a qualified audit report for fear of management retaliation (i.e. termination of the audit contract): Ibid.

[47] Ibid.

[48] Ibid.

[49] Fogarty, above n 22, 408.

[50] *Sarbanes-Oxley Act of 2002*, Pub L No 107-204, 116 Stat 745 (2002).

independence (‘*Ramsay Inquiry*’) and subsequently introduced *CLERP 9*,[51] which was enacted on 30 June 2004.[52]

The purpose of the Ramsay Inquiry was to:

> (a) examine the adequacy of existing Australian legislative and professional requirements about the independence of company auditors, having regard to recent overseas developments; and
> (b) make appropriate recommendations for changes to the Australian requirements.[53]

Professor Ramsay made a number of recommendations to strengthen auditor independence, many of which required amendments to previous section 324 of the *Corporations Act*,[54] which had not been materially updated for more than 40 years.[55] The recommendations included:

(a) amendment to the ASX Listing Rules to require listed companies to establish competent audit committees;[56] and
(b) introduction of mandatory audit *partner* rotation.[57]

The then Hon Joe Hockey MP welcomed Professor Ramsay’s report on 4 October 2001 stating:

> We must ensure the independence of auditors is preserved and that stakeholders are secure with the knowledge that the auditor is objective and independent. Professor Ramsay’s recommendations strike a good balance between safeguarding shareholders’ interests and preserving the commercial interests of public companies.[58]

B *Current regulatory framework*

In Australia, auditor independence is regulated by a combination of legislative provisions in the *Corporations Act*[59] and professional standards,[60] namely:

(a) Section 307C of the *Corporations Act*;[61]

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[51] Fogarty, above n 22, 408-409.
[52] *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (Cth) s 2.
[53] Ian Ramsay, Report to the Minister for Financial Services and Regulation, *Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform* (2001), 20.
[54] *Corporations Act 2001* (Cth) s 324.
[55] Ramsay, above n 53, 6.
[56] Ibid 15-16.
[57] Ibid 17.
[58] Joe Hockey, Minister for Financial Services and Regulation, ‘Strengthening Audit Independence’ (Press Release, FSR/077, 4 October 2001).
[59] *Corporations Act 2001* (Cth).
[60] The Auditing Standards are legislative instruments, enforceable under the s 307A of the *Corporations Act 2001* (Cth). Certain aspects of APES 110 also have legislative effect, by virtue of the Auditing Standards: Accounting Professional and Ethical Standards Board, *APES 110 – Code of Ethics for Professional Accountants* (December 2010), [1.4] (‘*APES 110*’).
[61] *Corporations Act 2001* (Cth) s 307C.

(b) Divisions 3, 4 and 5 of Part 2M.4 of the *Corporations Act*;[62]

(c) Auditing Standard ASQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements;[63]

(d) Auditing Standard ASA 220 Quality Control for an Audit of a Financial Report and Other Historical Financial Information;[64]

(e) APES 110 – Code of Ethics for Professional Accountants; [65] and

(f) APES 320 – Quality control for firms.[66]

Under the *Corporations Act*, an individual auditor, an audit company or an audit firm may be appointed as auditor of a company or registered scheme, provided the auditor is a registered company auditor.[67] This essay will focus primarily on the requirements for audit firms.

(a) Financial Reporting requirements

Part 2M.3 deals with 'Financial Reporting'.[68] Section 292 requires all disclosing entities,[69] public companies, large proprietary companies and registered schemes to prepare a financial report and directors' report for each financial year ('*Annual Report*').[70] The Annual Report must be audited and must include an auditor's report.[71] Where the company is listed, the annual directors' report must also include specific information regarding the provision of NAS by the audit firm and its impact on auditor independence.[72] In addition, disclosing entities must also prepare half-year financial reports and directors' reports and have the financial report audited or reviewed and obtain an auditor's report ('*Half-Year Report*' and together with Annual Report, '*Financial Reports*').[73]

An audit of the Financial Reports must comply with the auditing standards.[74] An auditor who audits the Financial Reports must form an opinion in relation to the matters outlined in section 307[75] and

[62] Ibid pt 2M.4 divs 3-5.
[63] Auditing and Assurance Standards Board, *Auditing standard ASQC 1 - Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements* (October 2009).
[64] Auditing and Assurance Standards Board, *Auditing Standard ASA 220 - Quality Control for an Audit of a Financial Report and Other Historical Financial Information* (June 2011).
[65] APES 110, above n 60.
[66] Accounting Professional and Ethical Standards Board, *APES 320 – Quality Control for Firms* (May 2009); See further Australian Securities and Investments Commission, Auditor independence and audit quality (29 April 2013) Australian Securities and Investments Commission <https://www.asic.gov.au/asic/asic.nsf/byheadline/Auditor+independence+and+audit+quality?openDocument>.
[67] *Corporations Act 2001* (Cth) ss 324AA, 324BA.
[68] Ibid pt 2M.3.
[69] 'Disclosing entity' is defined in s 111AC of the *Corporations Act 2001* (Cth).
[70] *Corporations Act 2001* (Cth) sub-s 292(1). Note: A small proprietary company and a small company limited by guarantee are only required to prepare such reports in certain limited circumstances: See sub-ss 292(2)-292(3), ss 293, 294, 294A, 294B.
[71] Ibid s 301. Note: the Annual Report of a small proprietary company or a company limited by guarantee only requires an audit in certain circumstances: see sub-ss 301(2)-(4).
[72] Ibid sub-s 300(11B). Note: under subsection 300(11D), the statements required under sub-paragraph 300(11B)(b) and (c) 'must be made in accordance with:

(a) Advice provided by the listed company's audit committee if the company has an audit committee; or
(b) A resolution of the directors of the listed company if paragraph (a) does not apply.'

[73] Ibid s 302.
[74] Ibid s 307A.
[75] Section 307 of the *Corporations Act 2001* (Cth) provides:

must report to members on whether the auditor is of the opinion that the relevant Financial Report is in accordance with the *Corporations Act*,[76] including that it complies with accounting standards[77] and gives a true and fair view.[78] If not of that opinion, the auditor's report must say why.[79] Further, the lead auditor must give the directors a written independence declaration.[80] Contravention of the auditor independence declaration provision attracts strict liability.[81]

As noted above, auditors must report certain contraventions of the *Corporations Act* and attempts to undermine the audit to ASIC.[82] The auditor of a listed company must also attend the Annual General Meeting.[83]

(b) Auditor independence requirements

Division 3 of Part 2M.4 deals with *'Auditor Independence'*.[84] Section 324CB contains general requirements for auditor independence. Subsection 324CB requires members of the audit firm to take reasonable steps to eliminate 'conflict of interest situations' as they arise.[85] *'Conflict of interest situation'* is defined in section 324CD as existing in relation to an audited body at a particular time if, because of circumstances that exist at that time:

> (a) the auditor, or a professional member of the audit team, is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body; or

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> (a) whether the report has been prepared in accordance with the *Corporations Act*,[75] including that it complies with the accounting standards (ss 296 or 304) and that it gives a true and fair view of the financial position and performance on the relevant entity (ss 297 or 305);
> (aa) if the financial report includes additional information under paragraph 295(3)(c) or 303(3)(c) (information included to give true and fair view of financial position and performance) – whether the inclusion of that additional information was necessary to give the true and fair view required by section 297 or 305;
> (b) whether the auditor has been given all information, explanation and assistance necessary for the conduct of the audit; and
> (c) whether the company has kept financial records sufficient to enable a financial report to be prepared and audited; and
> (d) whether the company has kept other records and registered as required by this Act.

[76] Ibid.
[77] Ibid ss 296, 304.
[78] Ibid ss 297, 305.
[79] Ibid ss 308, 309.
[80] Ibid sub-ss 307C(1), (3).
[81] Ibid sub-ss 307C(2), (4).
[82] Ibid s 311.
[83] Ibid s 250RA.
[84] Ibid pt 2M.4 div 3.
[85] Ibid sub-s 324CB(1). Subsection 324CB(1) provides:

> A person (the ***defendant***) contravenes this subsection if:
> (a) an audit firm engages in audit activity in relation to an audited body at a particular time; and
> (b) a conflict of interest situation exists in relation to the audited body at that time; and
> (c) the defendant is a member of the audit firm at that time; and
> (d) the defendant is or becomes aware of the circumstances referred to in paragraph (a) and (b); and
> the defendant does not, as soon as possible after the defendant becomes aware of those circumstances, take reasonable steps to ensure that the conflict of interest situation ceases to exist.

See also, sub-s 324CB(1A) which requires a member of the audit firm to notify ASIC if the 'conflict of interest situation' continues to exist after 7 days.

(b) a reasonable person, with full knowledge of all relevant facts and circumstances, would conclude that the auditor, or a professional member of the audit team, is not capable of exercising objective and impartial judgment in relation to the conduct of the audit of the audited body.[86]

Subsection 324CB(2) provides a strict liability offence where another member of the audit firm is aware of a 'conflict of interest situation' and the audit firm fails to take reasonable steps to eliminate the conflict.[87] Similarly, subsection 324CB(4) provides a strict liability offence where members of the firm are *unaware* of the existence of a 'conflict of interest situation', in circumstances where they would have been aware of the conflict if the firm had had a reasonable quality control system in place.[88]

In addition to the general auditor independence requirement in section 324CB, Division 3 of Part 2M.4 also contains specific auditor independence requirements for audit firms. The provisions essentially prohibit an auditor, subject to certain exceptions, from engaging in audit activity when certain key employment or financial relationships exists which are likely to impact negatively on the auditor's independence.[89] In addition, there are special rules for retiring partners of audit firms.[90]

(c) Auditor rotation requirements

Division 5 of Part 2M.4 sets out the auditor rotation requirements for listed companies. Subsection 324DA(1) sets out the primary rotation obligation:

> If an individual plays a significant role in the audit of a listed company or listed registered scheme for 5 successive financial years (the ***extended audit involvement period***), the individual is not eligible to play a significant role in the audit of the company or the scheme for a later financial year (the ***subsequent financial year***) unless:
>
> (a) the individual has not played a significant role in the audit of the company or the scheme for at least 2 successive financial years (the ***intervening financial years***); and
> (b) the intervening financial years:
>
> (i) commence after the end of the extended audit involvement period; and
> (ii) end before the beginning of the subsequent financial year.[91]

Section 324DC sets out offences relating to the rotation obligation for audit firms.[92]

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[86] Ibid sub-s 324CD(1). See also subsection 324CD(2), which sets out a range of relationships that may impact on auditor independence and which should be taken into account in determining whether a 'conflict of interest situation' exists: sub-s 324CD(2).
[87] Ibid sub-s 324CD(2).
[88] Ibid sub-s 324CB(4); Note, similar provisions exist in relation to individual auditors and audit companies: ss 324CA, 324CC.
[89] Ibid ss 324CE, 324CF, 324CG, 324CH.
[90] Ibid ss 324CI, 324CJ, 324CK.
[91] Ibid sub-s 324DA(1).
[92] Ibid s 324DC. Note: similar provisions exist in relation to individual auditors and audit companies: ss324DB, 324DD.

V MAFR

A *What is MAFR?*

As noted above, MAFR aims to reduce the 'familiarity threat' created by long audit firm tenure.[93] Section 207 of *SOX*[94] defines 'mandatory rotation' as 'the imposition of a limit on the period of years in which a particular registered public accounting firm may be the auditor of record for a particular issuer.'[95] The EC cites the following statistics as evidence of the problem:

> [A] FTSE 100 auditor remains in place for about 48 years on average; for the FTSE 250 the average is 36 years. It is noteworthy that Barclays has been audited by PWC or its predecessors since 1896. … At global level, nearly 60% of all Fortune 1000 public companies have had the same auditor for more than 10 years and 10% for 50 years or more.[96]

A number of countries currently have MAFR (eg Italy, Brazil and India); while others implemented and subsequently revoked MAFR (eg Spain and Canada).[97]

B *Historical considerations of MAFR*

1 *Australia*

MAFR is not a new concept. It was examined in 1997 by the Working Party of the Ministerial Council for Corporations:

> Submissions received by the Working Party showed little support for audit rotation. On the contrary, the anticipated cost, disruption and loss of experience to companies is considered unacceptably high, as is the unwarranted restriction on the freedom of companies to choose their own auditors.
>
> … the Working Party is disinclined to the view that the term of appointment should be fixed or that audit rotation should be mandated.[98]

MAFR was also considered during the Ramsay Inquiry, but was rejected for similar reasons.[99]

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[93] Stapledon, above n 33, 474.
[94] *Sarbanes-Oxley Act of 2002*, Pub L No 107-204, 116 Stat 745 (2002).
[95] Ibid § 207.
[96] European Commission, 'Impact Assessment accompanying the document Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts and a Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities' (Commission Staff Working Paper, European Commission, 2011), 17 ('*EC Impact Assessment*').
[97] Institute of Chartered Accountants Scotland, *What do we know about Mandatory Audit Firm Rotation?* (2012), 5.
[98] Working Party of the Ministerial Council for Corporations, *Review of Requirements for the Registration and Regulation of Company Auditors* (1997), 96.

2 *US*

MAFR was first proposed in the US in 1976 in the 'Metcalf Report':[100]

> Long association between a corporation and an accounting firm may lead to such close identification of the accounting firm with the interests of its client's management that truly independent action by the accounting firm becomes difficult. One alternative is mandatory change of accountants after a given period of years….[101]

It was subsequently considered and rejected by the Cohen Commission,[102] before reappearing as part of the *SOX* debates.[103] *SOX* aims to 'protect investors by improving the accuracy and reliability of corporate disclosures,'[104] including tightening auditor independence requirements. MAFR was considered by Congress as a possible regulatory tool; however, they opted for mandatory audit *partner* rotation.[105] Congress determined that further information was required in relation to the impact of MAFR; accordingly section 207 of *SOX*[106] required GAO to undertake a detailed study of the potential effects of MAFR.[107] GAO issued its report in November 2002.[108] It found:

> Nearly all [large] firms and Fortune 1000 public companies … believed that the costs of [MAFR] are likely to exceed the benefits. Also, … the audit firm partner rotation requirement of [*SOX*] …, or those partner rotation requirements coupled with other requirements of [*SOX*] that concern auditor independence and audit quality, will sufficiently achieve the benefits of [MAFR] when fully implemented. Our discussions with other knowledgeable individuals in a variety of fields … showed that most … held [consistent] views ....[109]

As such, GAO concluded that it was too early to determine whether the *SOX* amendments, including audit partner rotation, would be sufficient:

> [M]ore experience needs to be gained with the act's requirements. Therefore, the most prudent course at this time is for the SEC and the PCAOB to monitor and evaluate the effectiveness of the act's

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[99] Ramsay, above n 53, 95.
[100] PCAOB Proposal, above n 16, 10.
[101] Subcommittee on Reports, Accounting and Management of the Committee on Government Operations, US Senate, *The Accounting Establishment* (1976), 21 ('*Metcalf Report*').
[102] The Commission on Auditors' Responsibilities, *Report, Conclusions, and Recommendations* (1978); see also Sarah A Core, 'Only Fools Rush In: Mandatory Audit Firm Rotation and the PCAOB' (2013) *North Carolina Banking Institute* 137, 143-144. Note: the Metcalf Report raised concerns about the independence of the Cohen Commission, stating:

> '[l]ike the previous AICPA study groups, the Cohen Commission is comprised entirely of representatives from large accounting firms, large law firms, large investment firms, large corporations, and academic accountants, some of whom have ties to the 'Big Eight''.

Metcalf Report, above n 101, 119.
[103] Pamela B Roush et al, 'Auditor Rotation: The PCAOB Considers a New Direction' (2011) 5(2) *Current Issues in Auditing* 15, 16.
[104] *Sarbanes-Oxley Act of 2002*, Pub L No 107-204, 116 Stat 745 (2002).
[105] Ibid § 203.
[106] Ibid § 207.
[107] GAO Report, above n 15, 2.
[108] Ibid.
[109] Ibid 5.

> requirements to determine whether further revisions, including [MAFR], may be needed to enhance auditor independence and audit quality to protect the public interest.[110]

C *Arguments for MAFR*

This section sets out the principal arguments in favour of MAFR. As Core notes, it is apparent that a key theme underlies the various propositions (other than the costs argument), namely: 'new auditors are more independent and critical of public companies than current auditors.'[111]

1 *Improvement in 'independence in fact'*

Grant Thornton acknowledge in their submission to the PCAOB: 'no partner wants to be the one to lose a significant or long-standing relationship.'[112] Supporters argue that MAFR improves '*independence in fact*', as the limited duration of any client engagement lessens the pressure, and monetary and other incentives, for auditors to sacrifice their independence, and reputation, in order to 'keep the client'.[113] As a result, auditors may be more willing to challenge management on creative accounting and other financial reporting issues.[114] Arel et al argue that it may also assist in reducing the '"self-serving bias" that causes [auditors] to reach decisions that favour their own interests',[115] as the interests of the client/auditor may no longer be fully aligned.[116]

2 *Improvements in 'independence in appearance'*

As highlighted above, lengthy audit firm tenure implies a '*cosy*' relationship between auditor/client, which negatively impacts on an auditor's *appearance* of independence. Accordingly, proponents stress the improvements that MAFR can have on public perceptions of an auditor's independence.[117]

3 *Fresh eyes*

A further argument in favour of MAFR is that it will prevent 'staleness' resulting from 'repetition of earlier [audit] engagements'[118] and will lead to improved audit quality and audit integrity, as rotation allows 'fresh eyes' to review the company's financial statements and accounting practices/policies,

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[110] Ibid.
[111] Core, above n 102, 150.
[112] Grant Thornton LLP, Submission to Public Company Accounting Oversight Board, *PCAOB Release No. 2011-006, Rulemaking Docket Matter No. 37, Concept Release on Auditor Independence and Audit Firm Rotation*, 14 December 2011, 2 ('*Grant Thornton – PCAOB*').
[113] The Conference Board Commission on Public Trust and Private Enterprise, above n 20, 34; PCAOB Proposal, above n 16, 17; Cecily Raiborn et al, 'Should Auditor Rotation be Mandatory' (2006) *The Journal of Corporate Accounting and Finance* 37, 39; Core, above n 102, 153-154.
[114] The Conference Board Commission on Public Trust and Private Enterprise, above n 20, 34; Raiborn, above n 113, 39; Consumer Federation of America, above n 1, 3; Core, above n 102, 153-154; GAO Report, above n 15, 41.
[115] Barbara Arel et al, 'Audit Firm Rotation and Audit Quality' (2005) *The CPA Journal* 36, 38.
[116] Ibid.
[117] GAO Report, above n 15, 41; Raiborn, above n 113, 39.
[118] Arel, above n 115, 37.

as well as the previous firm's audit.[119] The International Federation of Accountant's Financial Reporting Supply Chain Report notes: 'Although there are concerns about loss of valuable knowledge and experience, long lead times to get-up-to-speed and more expensive audits, many respond that getting fresh eyes on the audit outweighs cost.'[120]

GAO present data on 'restatement rates' relating to 'fraud or error' in prior financial statements following the dissolution of Arthur Anderson in 2002, which necessitated forced auditor rotation for over 1200 public companies.[121] The data shows a marked increase in restatement rates for 'fraud and error' following auditor rotation.[122] However, as Core notes: '[t]hough the GAO offers this data as potentially persuasive research showing that "fresh look[s]" really do uncover mistakes and fraud under a MAFR-comparable scenario, the GAO stops short of making such a resounding conclusion.'[123]

4 *Watchdog*

Supporters argue that MAFR promotes diligence and conservative decision-making by auditors, as they will be aware, particularly towards the end of their term, that a new firm will be scrutinising their work with 'fresh eyes'.[124] This argument is clearly illustrated by the testimony of Biggs, Chairman, President and CEO of TIAA-CREF during the 2002 Congressional Hearings prior to the enactment of *SOX*:[125]

> Had Arthur Andersen in 1996 known that Peat Marwick was going to come in in 1997, there would have been a very different kind of relationship between them and Enron. Clearly, they would have wanted to have their work papers in order, all of the deals documented and well explained. They might well have challenged Enron's management in that early period where Enron was changing its accounting … I would think that there is a very high probability that had rotation been in place at Enron with Arthur Andersen, you would not have had the accounting scandal that I think we now have …[126]

Core refers to this as the 'watchdog' theory and highlights research in favour of the theory: 'This "watch dog" theory has garnered some academic support. A 2006 study found that auditors are more

[119] GAO Report, above n 15, 41; The Conference Board Commission on Public Trust and Private Enterprise, above n 20, 34; UK Financial Reporting Council, Submission to European Commissioner for Internal Market and Services, *Green Paper – Audit Policy: Lessons from the Crisis*, December 2010, 6.
[120] International Federation of Accountants, *Financial Reporting Supply Chain – Current Perspectives and Directions* (2008), 26.
[121] GAO Report, above n 15, 46; see also Core, above n 102, 152.
[122] GAO Report, above n 15, 46-47; see also Core, above n 102, 152.
[123] Core, above n 102, 152.
[124] The Conference Board Commission on Public Trust and Private Enterprise, above n 20, 34; PCAOB Proposal, above n 16, 17; Raiborn, above n 113, 40.
[125] *Sarbanes-Oxley Act of 2002*, Pub L No 107-204, 116 Stat 745 (2002).
[126] Evidence to Committee on Banking, Housing, and Urban Affairs, US Senate, Washington, 27 February 2002 (John H. Biggs).

likely to report a material misstatement against the client's wishes when audit rotation is pending than when the auditor relationship is ongoing and not constrained by MAFR.'[127]

5 *Mandatory Audit Partner Rotation is insufficient*

Opponents argue that MAFR is unnecessary as mandatory audit *partner* rotation provides adequate safeguards against the familiarity threat. However, as demonstrated in former SEC Chief Accountant Lynn Turner's testimony to the US Senate Committee on Banking, Housing and Urban Affairs, an incoming partner from the same firm is unlikely to challenge the work of the former partner:[128]

> One final argument you will hear against [MAFR] is that they already do an internal rotation of audit partners on the companies they audit … But once a firm has issued a report on the financial statements of a company, there is an inherent conflict in later concluding that the financial statements were wrong. This is especially true if the company has accessed the capital markets using those financial statements and as a result, that the accounting firm has significant exposure to litigation in the event of a restatement of the financial statements. By bringing in a new firm every 7 years, you get an independent set of eyes looking at the quality of the financial reporting that have no 'skin in the game' with respect to the previous accounting.[129]

6 *Costs*

Finally, while MAFR has obvious cost implications for audit firms and their clients, proponents argue the costs of audit failure trump MAFR costs.[130] Raiborn et al cite the following estimates in support of this proposition:

> Morgan Stanley estimates that the increased cost of [MAFR] would be approximately $1.2 billion per year, versus the $460 billion loss in market capitalization caused by the failures of Computer Associates, Enron, Quest, Tyco and WorldCom. The increase was calculated using $10 billion of audit fees in 2000 for the (then) Big Five, a 30 percent increase in audit fees for the first two years, and a rotation period of every five years.[131]

Further, it may be possible to reduce some of the costs associated with MAFR by requiring the exiting audit firm to handover its working papers to the new audit firm.[132]

[127] Core, above n 102, 155.
[128] EC Impact Assessment, above n 96, 17-18.
[129] Evidence to Committee on Banking, Housing, and Urban Affairs, US Senate, Washington, 26 February 2002 (Lynn E Turner).
[130] Raiborn, above n 113, 40; The Conference Board Commission on Public Trust and Private Enterprise, above n 20, 34.
[131] Raiborn, above n 113, 40.
[132] The Conference Board Commission on Public Trust and Private Enterprise, above n 20, 34.

D *Arguments against MAFR*

This section sets out the principal arguments against MAFR.

1 *Limited impact on 'independence in fact'*

The GAO Report states:

> [MAFR] is not a panacea that totally removes the pressures on the auditors in appropriately resolving financial reporting issues that may materially affect the public companies' financial statements. These inherent pressures are likely to continue even if the term of the auditor is limited under any mandatory rotation process.[133]

As highlighted by Grant Thornton, even under MAFR, auditors will be paid by the audit client and 'a company can still replace their auditor in any given year, with or without cause.'[134] Accordingly, it is unlikely that MAFR 'would fundamentally change the audit firm's relationship with management in a way that would address the perceived issuer-pay model conflict.'[135]Further, although the maximum length of tenure may be fixed (eg 10 years), the auditor will still be under pressure to 'please the client' so as not to lose the engagement early,[136] especially considering that the firm will have a shorter period within which to recoup start-up costs. Accordingly, opponents argue that MAFR is likely to have limited impact (if any) on independence in fact.

2 *Increased risk of audit failure*

A major argument against MAFR is that it will increase the risk of audit failure in the initial years post-rotation. The risk of audit failure is heightened where the client's business is particularly complicated; in a specialised industry or where the client is a multinational.[137] In its response to the PCAOB Proposal, the American Accounting Association ('*AMA*') makes reference to the Treadway Commission Report[138] and other research which 'suggests that a significant number of financial frauds involved companies that had recently changed their auditor … a greater proportion of audit failures occur on newly acquired audit clients.'[139] This increased risk of audit failure in the early

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[133] GAO Report, above n 15, 8.
[134] Grant Thornton PCAOB, above n 112, 4.
[135] Ibid.
[136] Arel, above n 115, 38.
[137] WeiserMazars, Submission to Public Company Accounting Oversight Board, *PCAOB Release No. 2011-006*, *Rulemaking Docket Matter No. 37, Concept Release on Auditor Independence and Audit Firm Rotation*, 14 December 2011, 2.
[138] National Commission on Fraudulent Financial Reporting, *Report of the National Commission on Fraudulent Financial Reporting* (1987) ('*The Treadway Commission*').
[139] Keith L Jones et al, 'Comments by the Auditing Standards Committee of the Auditing Section of the American Accounting Association on PCAOB Rulemaking Docket Matter No. 37: PCAOB Release No. 2001-006, Concept Release on Auditor Independence and Audit Firm Rotation' (2012) 6(1) *Current Issues in Auditing* 15, 17; see also Institute of Chartered Accountants Scotland, above n 97, 7.

years of an engagement is arguably linked to the lack of familiarity and deep-client knowledge that develops over the course of the engagement.[140] This issue is explored below.

3 *Loss of knowledge / familiarity*

A major concern with MAFR is the 'loss at fixed intervals of the auditors' cumulative knowledge of the companies they audit', leading to a loss of audit quality.[141] Following rotation, the incoming audit team faces a sharp learning curve to 'get up to speed' in relation to the client's business, practices, transactions and industry.[142] This period generally lasts two to three years, but could be longer for particularly complex or multinational clients.[143] This knowledge is essential to the audit process, as the auditor is less able to challenge management in relation to the preparation of the financial statements if it is unfamiliar with the client's business.[144]

In its submission to the PCAOB, Grant Thornton describes the challenges associated with knowledge loss as follows:

> With respect to audit effectiveness and audit diligence, there is no doubt that a learning curve exists, particularly in the year of transition. This does not mean, however, that auditors will disregard matters of audit quality or be less diligent, even when their term is coming to an end. What needs to be considered is the fact that more time and costs will be incurred to obtain the necessary evidence, particularly in the initial years of this engagement, while also meeting the issuer's filing deadlines. Audit firms face this challenge today, but the issue will become compounded with increased rotation, as potentially 10% of an audit firm's issuer clients may be new each year under a mandatory rotation regime of 10 years, as contemplated in the [PCAOB Proposal]. This challenge is particularly acute at larger multi-national entities …[145]

This argument clearly has merit, especially when considered in light of Deloitte research on the implementation impact of MAFR which indicates: 'If mandatory rotation were required at the 500 largest US companies, a 10 year phase-in process would entail 50 auditor changes every year compared to the recent average of five per year.'[146]

[140] GAO Report, above n 15, 6.
[141] PricewaterhouseCoopers, Mandatory Audit Firm Rotation – Why other changes would be better for investors (May 2012) PricewaterhouseCoopers, 1 <http://www.pwc.com/en_US/us/point-of-view/assets/mandatory-audit-firm-rotation.pdf>.
[142] WeiserMazars, above n 137, 2.
[143] GAO Report, above n 15, 19; European Banking Federation and Association for Financial Markets in Europe, *Mandatory audit firm rotation requirement under the European Statutory Audit Directive* (February 2012), 1-2.
[144] European Banking Federation and Association for Financial Markets in Europe, above n 143, 1-2.
[145] Grant Thornton PCAOB, above n 112, 4; see also BDO USA LLP, Submission to Public Company Accounting Oversight Board, *PCAOB Release No. 2011-006, Rulemaking Docket Matter No. 37, Concept Release on Auditor Independence and Audit Firm Rotation*, 14 December 2011, 5.
[146] Deloitte LLP, Submission to Public Company Accounting Oversight Board, *PCAOB Release No. 2011-006, Rulemaking Docket Matter No. 37, Concept Release on Auditor Independence and Audit Firm Rotation*, 8 December 2011, 2.

4 *Increased costs and fees*

It is argued that [MAFR] will lead to increased audit fees and costs, largely due to the 'learning curve' identified above.[147] According to the GAO Report, large firms:

> [E]stimated that initial year audit costs under [MAFR] would increase by more than 20 percent over subsequent year costs to acquire the necessary knowledge of the public company and most of the [large] firms estimated their marketing costs would also increase by at least more than 1 percent, which would be passed onto the public companies.[148]

To win new audit engagements, auditors frequently discount their fees by approximately 24 per cent in the first year.[149] Auditors typically absorb such costs; however under MAFR, firm rotation would become more common and the tenure period shorter (meaning there would a reduced tenure period within which to recoup such discounted fees), therefore audit firms will either have to pass the costs onto clients in the form of increased audit fees, or 'cut corners', which would reduce audit quality.[150] Furthermore, for multinational clients with complicated businesses structures, the 'first year' costs will be ever higher due to the steeper learning curve.[151]

In addition to the audit fees, management and the audit committee's time costs associated with selecting and inducting new auditors must also be taken in account.[152] According to GAO:

> Most Fortune 1000 public companies estimated that under [MAFR], they would incur auditor selection costs and additional auditor support costs totaling at least 17 percent or higher as a percentage of initial year audit fees.[153]

5 *Market concentration issues*

A further criticism of MAFR is that it will reduce market competition, which appears to have been the case in Italy and South Korea.[154] According to the GAO Report:

> 54 percent of [large] firms believe [MAFR] would decrease the number of firms willing and able to compete for audits of public companies and 83 percent of [large] firms believe that the market share

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[147] Jones, above n 139, 18; Raiborn, above n 113, 41.
[148] GAO Report, above n 15, 6.
[149] Jones, above n 139, 18.
[150] Ibid; WeiserMazars, above n 137, 4; Ernst and Young LLP, Submission to Public Company Accounting Oversight Board, *PCAOB Release No. 2011-006, Rulemaking Docket Matter No. 37, Concept Release on Auditor Independence and Audit Firm Rotation*, 18 November 2011, 11; BDO USA LLP, above n 145, 6-7.
[151] Jones, above n 139, 18.
[152] Ibid 20; WeiserMazars, above n 137, 3; Ernst and Young LLP, above n 150, 9; BDO USA LLP, above n 145, 6-7; PricewaterhouseCoopers, above n 141, 3.
[153] GAO Report, above n 15, 6.
[154] Institute of Chartered Accountants Scotland, above n 97, 8.

> of public company audits would either become more concentrated in a small number of public accounting firms or would remain the same.[155]

BDO International Limited's submission on the Green Paper states: 'The experience of BDO (and others) in Italy, where [MAFR] … is a long-established principle, is that such practice has resulted in a more pronounced concentration in the audit market, to the detriment of firms outside the largest four firms.'[156] Similarly, Grant Thornton submits to the PCAOB: 'If not appropriately implemented, [MAFR] would accelerate the current trend of large audits gravitating to a small group of firms and therefore, absent a change in audit buying patterns, will further negatively affect audit firm concentration.'[157]

In addition, concern has been expressed about the limited choice of audit firms, which makes MAFR impractical for some entities. The GAO Report notes: '[m]any Fortune 1000 public companies reported that they will only use a Big 4 firm for a variety of reasons, including the capability of the firms to provide them audit services and the expectations of the capital markets that they will use Big 4 firms.'[158] However, if one of the Big 4 firms is the current auditor, one provides prohibited NAS to the corporation and one is conflicted because it audits a competitor, this would leave the corporation with a choice of only one other Big 4 firm.[159] Further, as the GAO Report explains, this lack of choice may be compounded for large multinationals and companies operating in specialist industries, with particular audit requirements:[160]

> Not all audit firms have offices or staff located in all the geographic areas, whether domestically or internationally, where the clients conduct their operations, nor do all audit firms have personnel with certain industry knowledge to be able to perform audits of clients that operate in specific environments.'[161]

According to the Consumer Federation of America: '[a]bsent a break-up of the largest audit firms, there simply may not be a large enough pool of auditors available to make rotation for these firms practical.'[162]

[155] GAO Report, above n 15, 7; see also BDO USA LLP, above n 145, 7.
[156] BDO International Limited, Submission to European Commission, *Green Paper – Audit Policy: Lessons from the Crisis*, 8 December 2010, 12.
[157] Grant Thornton PCAOB, above n 112, 2.
[158] GAO Report, above n 15, 7.
[159] Ibid 41-42; Institute of Chartered Accountants in England and Wales, *Mandatory rotation of audit firms – Review of current requirements, research and publications* (2002), 19; International Federation of Accountants, above n 120, 25.
[160] GAO Report, above n 15, 41; Core, above n 102, 160.
[161] GAO Report, above n 15, 41; see also Core, above n 102, 160.
[162] Consumer Federation of America, above n 1, 5.

6 *Staffing issues*

Audit firms also express concern about the impact that MAFR would have on staff and the profession more generally. For example, Ernst and Young's ('*EY*') submission to the PCAOB highlights the following concerns:

> Constant rotation could make it difficult for audit firms to plan and provide career-enhancing assignments for their personnel in certain circumstances. … Managing transitions to multiple new engagements – which would include complexities such as the geographic relocation of a significant number of personnel – would increase the challenges and costs all audit firms already face in recruiting and retaining qualified personnel. The willingness of partners to relocate under the current mandatory five-year rotation arrangement … is challenging but manageable. Trying to apply forced rotation to entire teams of auditors would be extremely difficult and could cause professionals to seek other careers to avoid repeated geographic relocations. As a result, [MAFR] could result in higher turnover of staff and could ultimately make the profession less attractive.[163]

In addition, firms may experience difficulties in locating experienced staff to meet the demands of multinational engagements, particularly in industries where the firm has not traditionally specialised.[164] Further, when a multinational engagement ceases, it may not be possible to reassign staff to new roles unless the firm is engaged on another sufficiently similar engagement in terms of industry, client size and geographic location. This will create staff retention issues for firms.[165]

KPMG's submission to the PCAOB indicates that a transitory workforce may develop as a result of these staffing issues:

> Indeed, our experience with mandatory partner rotation leads us to believe that the costs and impracticality of constantly rotating entire audit teams likely would be prohibitive. As a result, the workforce providing public company audits would be hired on an as-needed and per-engagement basis. The evolution to a much more transitory workforce likely would lead to negative impacts on audit quality with further negative consequences for the vibrancy and sustainability of the private-sector public accounting profession over the longer term. [166]

7 *Specialisation*

Another criticism of MAFR is that the finite duration of the audit will discourage investment in:

(a) specialist knowledge of particular industries;

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[163] Ernst and Young LLP, above n 150, 10.
[164] BDO USA LLP, above n 145, 6.
[165] Ibid 6.
[166] KPMG LLP, above n 166, Submission to Public Company Accounting Oversight Board, *PCAOB Release No. 2011-006, Rulemaking Docket Matter No. 37, Concept Release on Auditor Independence and Audit Firm Rotation*, 13 December 2011, 10.

(b) tailored tools and controls relating to audit quality; and

(c) the client relationship.[167]

This will negatively impact on audit quality.[168] Audit firms currently devote significant resources to ensuring their auditors develop and maintain industry specific knowledge. For example, EY's submission to the PCAOB states: 'we have auditors who spend their careers concentrating and gaining expertise in particular industry sectors such as retail, technology, financial services, energy and transportation. This specialization increases the auditor's ability to perform high-quality audits in an industry sector.'[169]

AMA suggests as a result 'we will see a 'commoditization' of audits':[170]

> Audits could become much less client-specific and more targeted to apply to larger groups of clients in order to minimize switching costs resulting from [MAFR]. Auditors may have to become much more generalist than specialist in nature if their audit firm does not have a large presence in a particular industry, which would easily allow them to move across clients in the same specialty.[171]

8 *Audit committee can ensure rotation as required*

MAFR decreases the effectiveness of audit committees by 'reducing the audit committee's ability to determine which audit firm best meets the company's audit needs',[172] especially considering the lack of choice in the top end of the audit market.[173] As PricewaterhouseCoopers explains:

> Even among the largest accounting firms, there are significant differences in industry expertise, resources in US and global locations, and audit processes and tools utilized. [MAFR] may make the best qualified audit firm unavailable. Audit committees may therefore have to select a firm that does not have the highest level of industry expertise or resources in a given location.[174]

In addition, it would also remove the audit committee's power to determine when best to rotate auditors.[175]

Audit committees are a key corporate governance mechanism and are ideally placed to assess auditor independence. Accordingly, measures which constrain their function are arguably not in

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[167] Jones, above n 139, 18.
[168] Ernst and Young LLP, above n 150, 11.
[169] Ibid.
[170] Jones, above n 139, 18.
[171] Ibid.
[172] PricewaterhouseCoopers, above n 141, 1; see also KPMG LLP, above n 166, 10.
[173] Consumer Federation of America, above n 1, 5.
[174] PricewaterhouseCoopers, above n 141, 4; see also WeiserMazars, above n 137, 2-3; Ernst and Young LLP, above n 150, 7.
[175] KPMG LLP, above n 166, 10.

shareholders' best interests.[176] Moreover, GAO was of the view that audit committees could achieve much of the aims of MAFR:

> [I]f audit committees regularly evaluated whether audit firm rotation would be beneficial, given the facts and circumstances of their companies' situation, and are actively involved in helping to ensure auditor independence and audit quality, many of the benefits of audit firm rotation could be realized at the initiative of the audit committee rather than through [MAFR].[177]

9 *The 'revolving door' issue*

The AMA highlights that MAFR may not necessarily result in a change of the audit team, as staff from the former firm may follow the client to the new firm. This is most likely to occur where the rotation of a large audit client results in an oversupply of audit staff at the former firm and a demand for audit staff at the new firm, as was the case following the demise of Anderson. The AMA indicates:

> Small audits will not likely have a significant effect on staff turnover, but the rotation of large audit engagements could create a class of auditors who specialize in the audit of a specific company and rotate across firms with the audit client. Thus, it is not clear that mandatory firm rotation would have the desired effect on professional scepticism.[178]

In addition, staff from the former audit team may be enticed to the new firm to capitalise on their knowledge of the audit client. This 'revolving door'[179] may have negative long term ramifications on the former firm's staffing levels, including succession plans, which may also impact on audit quality.[180] According to the UK Financial Reporting Council ('*UKFRC*') 'there is evidence of unintended consequences where mandatory rotation has been introduced; for example, the core audit team moving en masse to the newly appointed firm.'[181]

10 *Inflexibility*

Another argument raised by opponents is '*inflexibility*'. Under MAFR, companies may be forced to change auditors at inopportune times, for example during a takeover or acquisition, diverting management attention at times of critical importance to the client's business.[182]

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[176] PricewaterhouseCoopers, above n 141, 3; WeiserMazars, above n 137, 2; Ernst and Young LLP, above n 150, 7.
[177] GAO Report, above n 15, 9.
[178] Jones, above n 139, 19.
[179] WeiserMazars, above n 137, 3.
[180] Ibid.
[181] UK Financial Reporting Council, above n 119, 21.
[182] KPMG LLP, above n 166, 11; BDO USA LLP, above n 145, 7.

E *Research on MAFR*

This section provides a high level overview of key research studies relating to:

(a) the impact of MAFR on auditor independence; and

(b) audit firm tenure and audit quality.

When taken as a whole, the research would appear to lend support to opponent's claims that MAFR will not improve audit quality, although there is some evidence that perceptions of 'audit quality' may improve.

1 *MAFR and auditor independence – evidence from Spain*

A 2009 study by Ruiz-Barbadillo et al considers the impact of MAFR on auditor independence[183] in Spain. MAFR was introduced in Spain in 1988, but was subsequently repealed in 1995.[184] Employing a 'sample of 1326 financially distressed Spanish companies'[185] the researchers 'examine the impact of rotation on audit reporting behaviour'[186] during the five year period before (1991-1994) and after (1995-2000) the abolition of MAFR. Ruiz-Barbadillo et al conclude that MAFR does not improve auditor independence: '[W]e find no evidence to suggest that a mandatory rotation requirement is associated with a higher propensity for auditors to issue a qualified audit opinion.'[187] However, they did discern a positive relationship between auditor independence and reputation, which was stronger in the absence of MAFR. The researchers conclude that: 'First, our empirical evidence suggests that mandatory rotation fails to enhance auditor independence. … Reputation concerns may help maintain auditor independence. … Thus mandatory rotation not only fails to enhance auditor independence, but may in fact harm independence.'[188]

2 *Audit firm tenure and audit quality*

A number of researchers have considered the link between audit firm tenure and audit quality. A high level overview of the findings of three such studies is set out below.

(a) Jackson et al

Jackson et al considered the impact of MAFR on audit quality using two proxies for audit quality, namely 'propensity to issue a going-concern opinion', [189] and 'the level of discretionary accruals'. [190] The authors concluded that 'audit quality increases with audit firm tenure' and therefore, '[MAFR]

[183] Emiliano Ruiz-Barbadillo et al, 'Does Mandatory Audit Firm Rotation Enhance Auditor Independence? Evidence from Spain' (2009) 28(1) *Auditing: A Journal of Practice and Theory* 113, 113.
[184] Ibid 114-115.
[185] Ibid 115.
[186] Ibid 114.
[187] Ibid 116.
[188] Ibid 132; see also Core, above n 102, 157-158.
[189] Andrew B Jackson et al, 'Mandatory audit firm rotation and audit quality' (2008) 23(5) *Managerial Auditing Journal* 420, 421.
[190] Ibid.

will not improve audit quality.' [191] The authors note, however, that although 'actual audit quality' [192] will not improve under MAFR, the 'perception of audit quality may indeed have increased'.[193]

(b) Myers et al

Myers et al examine the link between audit tenure and earnings quality. The authors conclude that earnings quality improves 'with extended auditor tenure under the current voluntary rotation system'. [194] In addition, the authors find:

> [S]ome evidence that longer auditor tenure is associated with less extreme income-increasing accruals. This suggests that as the relationship lengthens, auditors limit management's ability to use accruals to increase current period earnings. We also find evidence that longer auditor tenure is associated with less extreme income-decreasing accruals. This suggests that as the relationship lengthens, auditors limit management's ability to create reserves to manage future earnings.[195]

(c) Cameran et al

Cameran et al explore 'the effectiveness of MAFR by analysing how audit quality evolves over the allowed engagement period' for a sample of Italian listed companies from 1985-2004.[196] The authors conclude that audit quality tends to improve with extended auditor tenure:

> Therefore, there is significant audit quality deterioration after mandatory changes. This suggests that the learning effect tends to prevail over the deterioration of the auditor independence over the auditor engagement period. …Overall, our findings do not support the claims that [MAFR] is associated with audit quality improvements. These findings become even more interesting if one considers that our empirical analysis was carried out in a setting where – due to legal and audit environment features – the risk of collusion between auditor and auditee is expected to be even more relevant.[197]

[191] Ibid.
[192] Ibid 434.
[193] Ibid.
[194] James N Myers et al, 'Exploring the Term of the Auditor-Client Relationship and the Quality of Earnings: A Case for Mandatory Auditor Rotation?' (2003) 78(3) *The Accounting Review* 779, 780-781.
[195] Ibid.
[196] Mara Cameran et al, 'Does Mandatory Auditor Rotation Really Improve Audit Quality?' (Working Paper, 2010) <http://www.uc3m.es/portal/page/portal/inst_desarr_empres_carmen_vidal_ballester/investigacion/seminarios/seminarios_2010/Does%20mandatory%20auditor%20rotation%20really%20improve%20audit%20qua.pdf>, 5.
[197] Ibid 5-6.

VI CURRENT INTERNATIONAL CONSIDERATIONS OF MAFR

A *Green Paper*

On 13 October 2010, the EC issued the Green Paper, which canvassed various options for the reform of audit, including the possibility of MAFR. In relation to MAFR and re-tendering, the Green Paper noted:

> Mandatory rotation cannot only enhance the independence of auditors as discussed earlier; it could also operate as a catalyst to introduce more dynamism and capacity into the audit market. One could envisage a mandatory rotation of the audit firm / consortium after a fixed period. To prevent partners from changing firms to "take along" certain clients with them, rotation rules should ensure that not only firms, but partners are also rotated. Such mandatory rotation should be accompanied by mandatory tendering with full transparency as regards the criteria according to which the auditor will be appointed. Quality and independence should be key selection criteria in any tendering procedure. Otherwise, if only a very small proportion of audits of leading listed companies come up for open and fair tender in any given year, attempts to dynamise the market would have limited effect.[198]

A clear underlying concern in the Green Paper is the market concentration of the big accounting firms and the systemic market risk they pose:[199] '[i]n terms of the revenue or fees received, the total market share of Big Four audit firms for listed companies exceeds 90% in a vast majority of EU member states.'[200]

Submissions in relation to the Green Paper closed on 8 December 2010.[201] The EC received nearly 700 submissions from 'various stakeholders; these included members of the profession, supervisors, investors, academics, companies, government authorities, professional bodies and individuals'. [202]

On 30 November 2011, the EC issued two bold proposals,[203] which aimed to 'address the current weaknesses in the EU audit market, by eliminating conflicts of interest, ensuring independence and robust supervision and by facilitating more diversity in what is an overly concentrated market, especially at the top-end'.[204] The main proposals for the audit of public interest entities ('*PIEs*') included provisions for MAFR and mandatory tendering, as well as a ban on the provision of NAS to audit clients.[205] The proposals sent shock waves through the international audit community. The EC's Press Release described the reforms relating to MAFR and mandatory tendering as follows:

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198 Green Paper, above n 5, 16.
199 Ibid 4.
200 Ibid 15.
201 Ibid 21.
202 European Commission, 'Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts' Proposal (30 November 2011), 3.
203 European Commission, 'Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities' Proposal (30 November 2011); European Commission, 'Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts', above n 202.
204 European Commission, 'Restoring confidence in financial statements: the European Commission aims at a higher quality, dynamic and open audit market' (Press Release, MEMO/11/856, 30 November 2011), 1.
205 Ibid 2.

> Mandatory rotation of audit firms: Audit firms will be required to rotate after a maximum engagement period of 6 years (with some exceptions). A cooling off period of 4 years is applicable before the audit firm can be engaged again by the same client. The period before which rotation is obligatory can be extended to 9 years if joint audits are performed, i.e. if the entity being audited appoints more than one audit firm to carry out its audit, thus potentially improving the quality of the audit performed by applying the "four-eyes principle". Joint audits are not made obligatory but are thus encouraged.
>
> Mandatory tendering: [PIEs] will be obliged to have an open and transparent tender procedure when selecting a new auditor. The audit committee (of the audited entity) should be closely involved in the selection procedure.[206]

On 25 April 2013, the European Parliament's Committee on Legal Affairs voted in favour (15 votes to 10) of a diluted version of the proposals put forward by the EC, including provisions relating to MAFR and tendering for PIEs.[207] The measures are designed to '"… win back the confidence of investors"'.[208] A Press Release issued by the Committee on Legal Affairs described the MAFR proposals as follows:

> PIEs would be obliged to issue a call for tenders when selecting a new auditor. To ensure that relations between the auditor and the audited company do not become too cosy, MEPs approved a mandatory rotation rule whereby an auditor may inspect a company's books for a maximum of 14 years, which could be increased to 25 years if safeguards are put in place. The Commission had proposed 6 years, but a majority in committee judged that this would be a costly and unwelcome intervention in the audit market.[209]

The proposals must pass a number of additional stages before being enacted; [210] however reform in this area seems far from settled. The Irish Presidency of the EU has since recommended a 6 year MAFR period,[211] while the EU Competitiveness Council, has suggested a compromise proposal of '7 years (8 years for joint audits), renewable, subject to the satisfaction of certain criteria, for a maximum of 7 further years (8 for joint audits)'.[212] It is hoped that the proposals will pass the EU parliament by the end of the year. [213]

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[206] Ibid.
[207] Committee on Legal Affairs, European Commission, 'Reforming EU audit services to win back investors' confidence' (Press Release, 20130422IPRO7532, 25 April 2013), 1; Ken Tysiac, 'Europe takes step toward mandatory audit firm rotation' (2013) *Journal of Accountancy* < http://www.journalofaccountancy.com/news/20137862.htm>.
[208] Committee on Legal Affairs, above n 207, 1.
[209] Ibid.
[210] Tysiac, above n 207.
[211] Sara White, EU presidency calls for six-year audit rotation (29 May 2013) < http://www.accountancymagazine.com/croner/jsp/Editorial.do?channelId=-601045&contentId=2601134>.
[212] Council of the European Union, '3242nd Council Meeting - Competitiveness (Internal Market, Industry, Research and Space' (Press Release, 10142/13, 29-30 May 2013), 10; see also Suzanne Lynch, 'New EU auditing rules come closer' *The Irish Times* (online), 30 May 2013 <http://www.irishtimes.com/business/sectors/financial-services/new-eu-auditing-rules-come-closer-1.1411519>; White, above n 211.
[213] Tysiac, above n 207; Lynch, above n 212.

B US PCAOB Concept Release on Auditor Independence and Audit Firm Rotation

On 16 August 2011, the US PCAOB issued the PCAOB Proposal, which sought 'public comment on ways that auditor independence, objectivity and professional scepticism could be enhanced,'[214] including the possibility of MAFR.[215] Similar to ASIC, the PCAOB undertakes inspections of US public accounting firms and notwithstanding the introduction of *SOX*, it is concerned that it 'continues to find instances in which it appears that auditors did not approach some aspect of the audit with the required independence, objectivity and professional scepticism.'[216] In addition, the volume of incidences detected has increased.[217]

In particular, Chairman Doty sees lengthy audit tenure as a potential problem: '"In the early years of a relationship, the auditor might be trying to build a long-term relationship by pleasing the client. In later years, however, the incentive is to avoid being the engagement partner that lost the client."'[218] The PCAOB Proposal sought comments on a term of 10 years or longer.[219] The deadline for submissions closed on 14 December 2011,[220] but was subsequently extended to 19 November 2012.[221]

Jay Hanson, PCAOB Member has been reported as saying: 'implementation of [MAFR] was unlikely. Given a number of "hurdles", he said, "I'm sceptical as to whether we'd ever get there."[222] In relation to the PCAOB Proposal, Hanson stated: '"we have received almost 700 comment letters and have heard from dozens of panelists … Most commenters oppose mandatory rotation and express concern that auditor rotation will actually decrease audit quality."'[223]

In an address at the SEC and Financial Reporting Institute 30th Annual Conference, Chairman Doty stated:

> I believe it is incumbent on the PCAOB to take up the debate about firm tenure and examine it, with rigorous analysis and the weight of evidence in support and against. I don't have a predetermined idea as to whether the PCAOB ultimately should adopt term limits. My only predilection is that the PCAOB deepen the analysis of

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[214] PCAOB Proposal, above n 16, 1.
[215] Ibid.
[216] Ibid 2.
[217] Ibid 6; The PCAOB Proposal highlighted the following language extracted from a big accounting firm's proposal to a prospective audit client as an example of the lack of independence that it is uncovering and that it seeks to address:

> - Your auditor should be a partner in supporting and helping [the issuer] achieve its goals, while at the same time helping you better manage risk;
> - Support the desired outcomes where the audit team may be confronted with an issue that merits consideration with our National Office; and
> - Stand by the conclusions reached and not second guess our joint decisions.

Ibid 7.
[218] James R Doty, 'Rethinking the Relevance, Credibility and Transparency of Audits' (Speech delivered at SEC and Financial Reporting Institute 30th Annual Conference, Pasadena California, 2 June 2011).
[219] PCAOB Proposal, above n 16, 20.
[220] Ibid 1.
[221] Public Company Accounting Oversight Board, 'PCAOB Announces Panelists and Schedule of Appearances for October 18 Public Meeting on Auditor Independence and Audit Firm Rotation' (News Release, 15 October 2012; Core, above n 102, 139.
[222] Anne Rosivach, PCAOB Board Member sees Hurdles for mandatory Firm Rotation (6 December 2012) AccountingWEB <http://www.accountingweb.com/article/pcaob-board-member-sees-hurdles-mandatory-firm-rotation/220423>.
[223] Ibid. See also Ken Tysiac, 'U.K. regulator considering mandatory audit firm rotation' (2013) *Journal of Accountancy* <http://www.journalofaccountancy.com/News/20137442.htm>.

how we can better insulate auditors from client pressure and shift their mindset to protecting the investing public.[224]

Interestingly, the US House of Representatives passed (321 votes to 62) the Audit Integrity and Job Protection Bill on 8 July 2013.[225] The Bill seeks to amend *SOX* and would prohibit the PCAOB from introducing MAFR into the US.[226] It also requires further research into MAFR by way of an update to the GAO Report.[227] The Bill must still pass through the US Senate, however according to Barry Melancon, president of the American Institute of Certified Public Accountants: '"…the House has sent regulators in the US and Europe a clear message that the time has come to end the debate over rotation."'[228]

C UK CC considering MAFR

The CC is currently investigating the UK audit services market 'to determine whether any feature or combination of features of each relevant market prevents, restricts or distorts competition'.[229] On 22 February 2013, the CC issued its 'Summary of provisional findings'[230] and 'Notice of possible remedies'[231] to combat the 'provisional findings', including MAFR and mandatory tendering[232].[233] The CC found the UK audit market is characterised by long auditor tenure.[234] It also provisionally identified certain 'relevant features of the market'[235] which result in an adverse effect on competition ('*AEC*') including:

(a) 'barriers to switching', where 'companies and audit firms invest in a relationship of mutual trust and confidence from which neither will lightly walk away as this means the loss of the benefits of continuity stemming from the relationship';[236] and

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[224] Doty, above n 218.
[225] Tracy Alloway, 'US lawmakers block 'auditor rotation', *Financial Times (online)*, 9 July 2013 <http://www.ft.com/intl/cms/s/0/31c73408-e830-11e2-babb-00144feabdc0>; Peter Van Donhen, 'Mandatory audit firm rotation lacks merit', *Australian Financial Review* (Australia), 12 July 2013, 35; Richard Crump, US accountants applaud mandatory audit rotation block (9 July 2013) Accountancy Age < http://www.accountancyage.com/aa/news/2280238/us-accountants-applaud-mandatory-audit-rotation-block>.
[226] Audit Integrity and Job Protection Bill of 2013, H. R. 1564 (2013), § 2.
[227] Ibid § 3.
[228] Alloway, above n 225.
[229] Competition Commission, Statutory Audit Services Market Investigation, *Summary of provisional findings* (2013), 1.
[230] Ibid 3.
[231] Competition Commission, Statutory Audit Services Market Investigation, *Notice of possible remedies under Rule 11 of the Competition Commission Rules of Procedure* (22 February 2013).
[232] In relation to the proposed mandatory tendering option, which would not apply on a 'comply or explain basis', the CC states:

> 19. We are aware that under the FRC's recently revised [UK Code], FTSE 350 companies should put the external audit contract out to tender at least every ten years or explain why they have not done so. We consider that a greater frequency of tendering may be required to address effectively the AEC we have found.
>
> 20. We consider that the optimal period of tendering will reflect a balancing of the costs of the tender process and the benefits to be obtained from increased frequency of tendering. We propose two options of tender periods for comment, namely five and seven years …

Ibid 4-5.
[233] Tysiac, above n 223.
[234] Competition Commission, above n 229, 3.
[235] Ibid 10.
[236] Ibid 10-11.

(d) ‘Auditors have misaligned incentives, as between shareholders and company management, and so compete to satisfy management rather than shareholder demand, where the demands of executive management and shareholders differ.’[237]

The CC envisages that mandatory tendering would be combined with MAFR, both of which would be conducted on an ‘open book’ basis:[238]

> We consider [the MAFR] remedy is related to remedy 1 (mandatory tendering) and could be specified as a variant to it. For example, we may envisage a formulation whereby mandatory tendering (as in remedy 1) were required after a number of year, but if the same firm were retained then there would be a back-stop date by which time the firm had to be rotated: this might be after, for example, two tender periods.[239]

The CC is considering MAFR at seven, ten and 14 year periods.[240] The UKFRC has reportedly expressed concern over the CC’s proposals to introduce mandatory tendering and MAFR, with Stephen Hadrill, the UKFRC’s chief executive, stating the proposals could ‘“artificially constrain businesses’ choice of audit firm”’.[241] Further, Economia reports:

> Mandatory tendering, Hadrill says, would remove the flexibility of ‘comply or explain’. It could lead to retendering in an inappropriate year, contrary to investor’s interests, for example when the challenges facing a business, such as a major restructuring or takeover defences, make audit continuity important. “Such an outcome is inconsistent with the commission’s objective of ensuring auditors better serve the needs of shareholders.”
>
> As for mandatory rotation, the FRC is adamant that companies need to be able to get the best auditor for their business and so should not have their choice artificially constrained. “This is particularly necessary when not all audit firms have expertise in a company’s business area – such as insurance and banking.”[242]

Laura Carstensen, Chairman of the CC’s Audit Investigation Group states in the CC’s News Release:

> “It will undoubtedly be challenging to change a long-standing and entrenched system but our proposals will look to create a situation where tendering and switching become the norm, and where greater transparency and information increase both contestability of the market and the ability of shareholders to judge the service they are getting. We also want to increase their influence – and that of the audit committee – over the choice of auditor.”[243]

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[237] Ibid 11.
[238] Competition Commission, above n 231, 4.
[239] Ibid 6.
[240] Ibid 6.
[241] Julia Irvine, Julia, FRC warns over mandating audit change (20 March 2013) Economia < http://economia.icaew.com/news/march-2013/frc-warns-over-mandating-audit-change>.
[242] Ibid.
[243] Competition Commission, ‘Audit market not serving shareholders’ (News Release, 22 February 2013).

Comments on the 'provisional findings' closed on 21 March 2013,[244] while comments on the 'possible remedies' closed on 18 March 2013.[245] The final report is expected by 20 October 2013.[246]

VII ALTERNATIVES TO MAFR

A number of alternatives to MAFR have been proposed in the literature, including the 'Lottery' and 'Insurance' Models outlined below. In addition, the UK has introduced the *UK Re-tendering Regime*. Each of these options is canvassed below.

A *Lottery Model*

According to Bazerman et al '[u]nder current institutional arrangements, it is psychologically impossible for auditors to maintain their objectivity.'[247] This is because 'auditors' judgments are likely to be biased in favour of their own and their client's interests'.[248] The Lottery Model aims to sever the company's 'control over the hiring, firing and compensation of auditors', [249] thereby removing the inherent bias in the auditor/company relationship and promoting auditor independence. [250]

Kahn and Lawson describe the Lottery Model as follows:

> Our suggestion is that auditors be selected at random – literally by lot – from among a group of willing candidates. Once an auditor is selected for the engagement, that auditor should be removable only for cause and the removal should require the approval of some entity other than the audited firm's management. One could, if so inclined, add other elements to the plan, such as a rotation scheme that would require selection of a new auditing firm after a specified number of years (perhaps five years, which is the period chosen by [*SOX*] for the rotation of lead auditors) and a complete prohibition on the provision of any [NAS] to the audited firm or its management. But the essence of our proposal is to change the methods of auditor selection and retention in a way that reduces management control over the financial reporting process.[251]

Kahn and Lawson envisage that a regulatory body would be responsible for undertaking the lottery and setting auditor fees:[252] '[e]ach public company would pay into a fund, which would then pay auditors the prevailing rates for accountants working in the same area and markets.'[253] Kahn and Lawson argue that the

[244] Competition Commission, above n 231, 2.
[245] Ibid; Tysiac, above n 223.
[246] Tysiac, above n 223; see also Tysiac, above n 207.
[247] Max H Bazerman et al, 'The Impossibility of Auditor Independence' (1997) *Sloan Management Review* 89, 90.
[248] Ibid 93.
[249] David B Kahn and Gary S. Lawson, 'Who's the Boss? Controlling Auditor Incentives through Random Selection' (2004) 53 *Emory Law Journal* 391, 394.
[250] Ibid.
[251] Ibid 413.
[252] Ibid 414-415.
[253] Ibid 415.

Lottery Model 'would offer substantial benefits with few costs'[254] and would greatly enhance auditor independence by removing the need for auditors to oblige the client to ensure a continued income stream. [255]

Kahn and Lawson appreciate that the Lottery Model represents a radical shift from the status quo, but argue that it is 'modest'[256] in comparison to proposals to have government hired auditors which 'would essentially mean the destruction of the modern accounting industry and its transformation into a government bureaucracy.'[257]

B *Insurance Model*

Similar to the Lottery Model, the Insurance Model proposed by Ronen is predicated on the need to remove the agency relationship between auditor/client: '[w]e need to create instead an agency relationship between the auditor and an appropriate principal – one whose economic interests are aligned with those of investors, who are the ultimate intended beneficiaries of the auditor's attestation.'[258]

Ronen describes the Insurance Model as follows:

> Financial statement insurance (FSI) would make for a significant change in the principal-agent relationship. Instead of appointing and paying auditors, companies would purchase FSI that provides coverage to investors against losses suffered as a result of misrepresentation in financial reports. The insurance coverage that the companies are able to obtain is publicized, along with the premiums paid for the coverage. The insurance carriers then appoint – and pay – the auditors who attest to the accuracy of the financial statements of the prospective insurance clients. Those announcing higher limits of coverage and smaller premiums will distinguish themselves in the eyes of the investors as the companies with higher quality financial statements. In contrast, those with smaller or no coverage or higher premiums will reveal themselves as those with lower quality financial statements. Every company will be eager to get higher coverage and pay smaller premiums lest it be identified as the latter. [259]

Although the insurer's interests appear to be consistent with those of investors, [260] Kahn and Lawson doubt the effectiveness of the Insurance Model as it 'does not come to grips with the economic incentives that drive such insurance transactions. … The goal of insurance companies is not to minimize claims against their insured clients.'[261]

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[254] Ibid 418.
[255] Ibid 415.
[256] Ibid 423.
[257] Ibid 423.
[258] Joshua Ronen, 'Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited' (2002) 8 *Stanford Journal of Law, Business and Finance* 39, 48.
[259] Ibid.
[260] Ibid 53.
[261] Kahn, above n 249, 426.

C UK Re-tendering Regime

On 20 April 2012, the UKFRC released a Consultation Document regarding proposed amendments to the UK Code, including a proposal that 'FTSE 350 companies will be expected to put the audit contract out to tender at least every ten years'[262] on a 'comply or explain' basis.[263] EY,[264] KPMG[265] and Deloitte[266] made submissions against the tendering proposal, citing amongst others, issues of cost, downward pressure on audit fees, negative implications for audit quality and competition, as well as the sufficiency of audit *partner* rotation.[267] The US Center for Audit Quality also opposed the proposal arguing 'the environment created by retendering requirements runs the risk of creating a "sales culture" at firms with unintended consequences such as pricing pressures.'[268] In contrast, PricewaterhouseCoopers was mildly supportive:

> We do not accept that long tenure impairs an auditor's independence or the quality of the audit. Furthermore we do not support mandatory tendering. … In a UK context, however, given the strength of the corporate governance environment and the understanding of a comply or explain approach, we acknowledge the view that more regular tendering using this particular approach could help to further counteract this misconception, by demonstrating that the quality of the audit is periodically subject to competitive challenge.[269]
>
> However there are risks to more regular tendering. To mitigate potentially negative outcomes from the proposal it will be necessary to ensure that … it is absolutely clear that a valid outcome of the tendering process is retention of the incumbent auditor – the vast majority of large companies are against mandatory rotation.[270]

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[262] The UK Code's tendering regime is similar to the tendering proposal put forward by Richard Breeden, former SEC Chairman, in his evidence to the US Committee on Financial Services prior to the introduction of *SOX*:

> At present, I do not believe that mandatory rotation would be appropriate. ... Rather than mandatory rotation, auditor retentions by an audit committee should be made for a longer term, such as three or four years. Today the annual selection of the auditor happens so often that it is treated as a matter of routine. Thus, a very important decision is to a degree trivialised by the frequency it is made.
>
> A better system would be for the audit committee to appoint the auditors to a three or four year contract that could only be terminated by the committee. At the end of this longer engagement, the audit committee should solicit proposals from multiple firms as to the next award of the audit mandate. This would ensure that every four years at least the audit committee would devote serious time to the issue of whether a rotation of auditors would serve the best interests of the shareholders. In considering whether to renew the incumbent auditor, the audit committee should strongly consider a new firm if the company had restated its earnings or been the subject of proceedings relating to inaccuracy of publicly reported financial results, or if the auditors failed to notify the audit committee of the existence of significant audit or accounting issues. These are judgements best left to the board and audit committee, however.
> Evidence to Committee on Financial Services, US House of Representatives, Washington, 13, 20 March 2002, 9 April 2002, 475-476 (Richard C. Breeden)

[263] UK Financial Reporting Council, *Revisions to the UK Corporate Governance Code and Guidance on Audit Committees*, Consultation Document (2012), 1.

[264] Ernst and Young, Submission to Financial Reporting Council, *Revisions to the UK Corporate Governance Code and Guidance on Audit Committees*, 13 July 2012.

[265] KPMG LLP, Submission to Financial Reporting Council, *Revisions to the UK Corporate Governance Code and Guidance on Audit Committees*, 2 July 2012.

[266] Deloitte, Submission to Financial Reporting Council, *Revisions to the UK Corporate Governance Code and Guidance on Audit Committees*, 10 July 2012.

[267] Ibid 3; Ernst and Young, Submission to Financial Reporting Council, above n 264, 2; KPMG LLP, Submission to Financial Reporting Council, above n 265, 6.

[268] Center for Audit Quality, Submission to Financial Reporting Council, *Revisions to the UK Corporate Governance Code and Guidance on Audit Committees*, 13 July 2012, 2.

[269] PricewaterhouseCoopers LLP, Submission to Financial Reporting Council, *Revisions to the UK Corporate Governance Code and Guidance on Audit Committees*, 6 July 2012, 2.

[270] Ibid. Note: Grant Thornton proposed 'Mandatory tendering' on a 'comply or explain' basis as an alternative to MAFR in its submission regarding the PCAOB Proposal. It stated:

The revised UK Code was released on 28 September 2012.[271] The UK Code contains a series of 'Main' and 'Supporting' principles and 'Code' provisions.[272] It 'applies to all companies with a Premium listing of equity shares regardless of whether they are incorporated in the UK or elsewhere.'[273] The UK Listing Rules set out in the UK Financial Conduct Authority Handbook[274] require companies with a Premium listing of equity shares 'to apply the 'Main Principles' and report to shareholders on how they have done so.'[275] The UK Code applies on a 'comply or explain' basis, which provides companies with flexibility in applying the provisions.[276] Deviation from the provisions of the Code is allowed, provided the relevant entity clearly explains its reasoning to shareholders.[277]

Section C.3 sets out the provisions relating to Audit Committee and Auditors. The 'Main Principle' states: '[t]he board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditors.'[278] The relevant 'Code Provisions' relating to the UK Re-tendering Regime include C.3.7, which provides:

> The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. FTSE 350 companies should put the external audit contract out to tender at least every ten years. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendations and should set out reasons why the board has taken a different position.[279]

In addition, Provision C.3.8 provides:

> A separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include:
>
> - …

> We believe that there is some merit in considering measures such as regular tendering with greater transparency around the appointment decision. With respect to such measures, we believe that a "comply or explain" framework should be considered. A "comply or explain" framework would allow audit committees to maintain responsibility for corporate governance, as it would enable audit committees to describe to investors and other constituents the reasons for decisions to retain or change audit firms.

Grant Thornton LLP, Submission to Public Company Accounting Oversight Board, *PCAOB Release No. 2011-006, Rulemaking Docket Matter No. 37, Concept Release on Auditor Independence and Audit Firm Rotation*, 14 December 2011, 7.

[271] UK Financial Reporting Council, 'FRC publishes updates to UK Corporate Governance Code and Stewardship Code' (Media Release, FRC PN 101, 28 September 2012).

[272] UK Financial Reporting Council, *The UK Corporate Governance Code* (September 2012), 4 ('*UK Code*').

[273] Ibid 1.

[274] UK Financial Conduct Authority, *Financial Conduct Authority Handbook,* Listing Rules: Chapter 9 (2013).

[275] UK Code, above n 272, 4.

[276] PricewaterhouseCoopers LLP, Submission to Financial Reporting Council, above n 269, 1.

[277] UK Code, above n 272, 4; UK Financial Reporting Council, *What constitutes an explanation under 'Comply or explain'? Report on discussions between companies and investors* (2012).

[278] UK Code, above n 272, 18.

[279] Ibid 19-20.

- an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, and information on the length of tenure of the current audit firm and when a tender was last conducted.[280]

Jo Iwasaki, Head of Corporate Governance at the Institute of Chartered Accountants in England and Wales, welcomed the amendments: "This may help alleviate the perception that long tenure reduces audit quality and auditor independence"'[281], while '"[a]t the same time, providing 'explain' as a genuine alternative to 'comply' would give businesses the freedom to carry out tendering at a time when it is right for them."'[282]

VIII CONCLUSION

This essay has considered the concept of MAFR to determine whether it would be an effective means of improving auditor independence in Australia. Although the 'fresh look' and 'watchdog' arguments may have merit, and there appears to be some evidence to support the contention that MAFR will improve 'independence in appearance' by reducing perceptions of 'cosiness', on balance, the costs of MAFR would appear to outweigh the supposed benefits. Of particular concern is the potential negative impact that MAFR would have on market competition, the already limited choice of audit firms, specialisation, careers and audit committee effectiveness. Further, the research in relation to audit firm tenure and audit quality do not support MAFR.

This essay has outlined three possible alternatives: the 'Lottery' Model, the 'Insurance' Model and the UK Re-tendering Regime. Although the 'Lottery Model' has much to commend it in terms of improving independence in both fact and appearance by removing the client's control over the auditor's income stream and appointment; it is a relatively radical proposal, which is unlikely to garner much political support. The Insurance Model appears to be less workable and is also unlikely to gain political favour.

In contrast, the UK Re-tendering Regime appears to be a good compromise. Arguably it would offer similar benefits to MAFR, namely increased 'independence in appearance', a 'fresh look' and the 'watchdog' effect, while tempering some of the negative aspects of MAFR through the flexibility of the 'comply or explain' regime. The role of audit committees would be enhanced rather than diminished under this proposal. Further, companies would have the flexibility to undertake a rotation when it is most suitable to the company. In addition, provided the audit committee meets the 'comply or explain' requirements, they would have unfettered discretion to choose the best auditor for the job. Accordingly, specialisation should be less at risk, which will also hopefully lessen the negative impact on careers. Finally, although there will be loss of

[280] Ibid 20.
[281] Jordans, Ten-year audit tendering introduced in UK Governance Code (1 October 2012) Jordans Limited <http://www.jordans.co.uk/newsandpressreleases/tenyear_audit_tendering_introduced_in_uk_governance_code.html>.
[282] Ibid.

knowledge upon rotation and therefore, a heightened risk of audit failure in the early years, the flexible nature of the regime should mean that there is a smaller volume of rotations in any given year. There will undoubtedly be costs associated with the tendering process and firm rotations; however, if such measures assist in reducing 'Enron scale' audit failure, arguably the cost increase is justified.

Accordingly, the better option for Australia would appear to be a form of re-tendering similar to the UK Re-tendering Regime rather than MAFR. Helpfully, Australian listed entities[283] are bound by the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* ('*ASX Code*').[284] Similar to the UK Code's 'comply or explain' regime, compliance with the ASX Code is flexible, on an 'if not, why not' basis and Principle 4 deals with 'Safeguard[ing] integrity in financial reporting'.[285] As such, the ASX Code could be amended to include additional Recommendations in relation to 're-tendering', along the lines of those introduced into the UK Code.

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[283] ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations with 2010 Amendments* (first published 2007, 2nd ed), 7.
[284] Ibid.
[285] Ibid 11.

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