Mandatory Auditor Rotation

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Publicly traded companies are not required to change periodically which CPA firm performs their annual financial audit. However, CPA firms are required to rotate the audit partner assigned to an audit after five years. Should there be mandatory CPA firm rotation instead of audit partner rotation?

Many publicly traded companies have used the same CPA firm for their financial statement audit for decades. The companies would only change the CPA firm performing their audit for a good reason. The reason might be as simple as a shift in the personnel by the CPA firm or the company. A more serious reason might be a strong difference of opinion regarding the proper accounting for a financially significant item. The CPA firm may decide not to renew an engagement due to concerns about their potential legal liability exposure related to a particular audit client. A publicly traded company dropped by their CPA firm probably would be a high-risk client for the CPA firm accepting the new company. In essence, the new client would be a high-risk client because a CPA firm either dumped them or they were “opinion shopping.”

Some CPA firm partners suggest audit risk is higher during the first or second year of an audit. More audit failures occur when a CPA firm is new to an audit. The implication is that the root cause of the CPA firm’s audit failure is the newness of the audit and lack of experience by the CPA firm. The publicly traded company may have switched CPA firms because the company is a high risk, instead of the CPA firm being high risk. Another possibility is the company may believe that changing auditors is in the best long-term interests of the stakeholders. Under current regulations, which do not require rotation, new audit engagements have higher audit risk; however, that would not be true if a firm takes on a new client due to mandatory rotation. Along with mandatory rotation, CPA firms should be required to disclose detailed client information, including work papers to successor auditors so that the learning curve is not as steep and audit risk is reduced (the predecessor auditor ordinarily permits the successor to review working papers, but there are limitations on this and the audit client may need to authorize access).

CPA firms are generally opposed to mandatory auditor rotation. However, the CPA firms that audit public companies have just recently been required to rotate the audit partner for an engagement once every 5 years. CPA firms do not want audits to be shifted to other firms after 5 to 10 years. There may even be some CPA firms that would like to violate the spirit of the new rule by rotating the assigned audit partner after the fourth year and bringing them
back for the sixth through the tenth years. It is only natural for the CPA firms to view their audit clients as customers that have been acquired and they wish to retain these customers. The higher the rate of customer retention, the smoother the staffing needs, the better trained the audit staff for the engagements, and the more certain the CPA firm profit level. What we are starting to see is a shift from auditors providing a service to auditors becoming overseers or regulators of businesses.

The Securities and Exchange Commission could require publicly traded companies to disclose in their annual reports which CPA firms conducted their annual financial audit during each of the last 30 years. Investors may be able to make logical inferences from the disclosure. For example, if a company has had the same auditor for 30 years, the investor may decide that the relationship between the company and the CPA firm is too cozy. If a company has changed auditors every 3 to 6 years, the company may be using aggressive accounting practices, which may be causing conflict with their auditors. If such disclosures were required, the information might indirectly push for more appropriate practices.

The younger accountants and auditors prefer mandatory auditor rotation every five years. The more seasoned accountants and auditors prefer mandatory auditor rotation at least every ten years. The correct answer probably is somewhere between these numbers.

As noted earlier, many accountants and auditors believe that auditor rotation should be mandated. Even though the companies and the CPA firms may oppose mandatory auditor rotation, a majority of accountants and auditors probably believe that most investors are best served by periodic rotation of auditors. The publicly traded companies should be required to rotate CPA firms once every seven years.