Mandatory Audit Firm Rotation

I am writing to express my great concern that mandatory auditor rotation will result in a decline in audit quality and financial reporting not the improvement its sponsors anticipate.

I am a retired audit partner of PricewaterhouseCoopers having spent 40 years with the legacy Price Waterhouse firm and then PWC. Most of my career and my 27 years as an audit partner were devoted to audits of large, multinational public companies. Relevant to the topic at hand, I was also the principal author of the firm’s first edition of “Improving Audit Committee Performance.”

My background coupled with the fact that as a retired partner I have no direct “skin in the game” will hopefully add weight to my concerns. I will also offer alternatives to auditor rotation.

I do not argue that auditor rotation should not be mandated because of increased audit costs that would result. The cost of audits will certainly increase significantly with mandatory rotation as “new” audit firms will have to expend a great deal of time in an attempt to familiarize themselves with their new client’s operations. However, in my view, if it were to be determined that mandatory rotation would help improve audits and financial reporting, so be it. The increased cost would be a cost of doing business as a public company.

I believe experienced auditors would generally agree that an audit firm’s initial year(s) as auditor of a company is at much higher risk of audit failure due to the new firm’s lack of “accumulated knowledge” of the company’s business. To perform an effective audit, the auditor must “audit the business,” not merely the debit and credits. There is no way to audit the business unless the auditor understands the business. Until that understanding is achieved, the auditor is at much higher risk of approving inappropriate accounting which, on the surface, appears to be appropriate, but which is not appropriate in that particular company’s case.

Gaining an understanding of the business takes time for a company of any size. But
imagine how long it takes to gain an understanding of a business operating in multiple industries, in thousands of locations in over 70 countries and doing business in 180 countries around the world – a description of my last audit client. Not only must the corporate headquarters audit team gain an understanding of the company’s various businesses, but so must the firm’s auditors in the 70 countries around the world. And those “understandings” must be consistent if a good audit is to be the result. Just how effective will the audit be during that “learning” period, especially if company management has a tendency to play fast and loose with the rules – the very condition the supporters of audit rotation is attempting to address?

One might reasonably ask how in a recurring audit, a new lead audit partner gains the knowledge necessary to lead an effective audit. The answer, of course, is the existing firm’s knowledge about the client accumulated over time. This knowledge resides not only in working papers, but in other partners and staff around the world who have been auditing the respective parts of the company. It also resides in the firm’s National Office technical partners and staff. It is also likely that prior to becoming the lead audit partner, the new engagement partner has had some experience with the company – either as some time spent as second partner or as a partner for a division of subsidiary of the client company.

As an audit partner who has been in the position of a new engagement partner on major multinational companies, I can tell you it would take a couple of years, at minimum, to get up to speed absent other partners and staff with experience on the client. Reviewing audit working papers of another firm can only get you so far, and once the review has been completed, that’s it; if you didn’t note a matter then, you are out of luck.

I am convinced that mandatory rotation to reduce the likelihood of audit failures could well have exactly the opposite effect as a result of the new auditor not sufficiently understanding the complexities of the new client. After all, fresh, “skeptical” eyes are only useful if they fall on the right issue. I don’t mean to imply that it is impossible to have a smooth, effective transition to a new audit firm; just that it can be very problematic.

Some have expressed concern that without mandatory firm rotation a partner or firm might “get to close” to the client and permit the client to “cut corners” or engage in outright fraudulent reporting to keep the firm from losing a client. I am sure there are partners, and perhaps firms, where that may be, or has been, the case. But, I submit that a partner or firm that would do that to not lose a fee, would also do that in a mandatory rotation environment in order to keep from losing a client before the mandatory rotation time is up.

I do have some recommendations to make in support of improved audit quality which would not involve the audit risk attendant with mandatory rotation of audits for all public companies.

I understand there is a proposal to have the engagement partner personally sign the audit
report in his own name as well as the firm name. I think that would be an excellent idea and would reinforce his or her personal responsibility for the firm’s audit report.

Public companies should be required to keep detailed minutes of matters discussed at audit committee meetings – especially discussions of close calls, accounting for new or complex transactions, inquiries made by audit committee members and auditor responses, and the results of the auditor’s consultations with the firm’s national office on accounting, auditing or reporting issues. PCAOB’s reviews of audits should include a review of those minutes and follow up on action taken as a result of those discussions.

In the event of an audit failure, the SEC (or PCAOB) should determine if matters giving rise to the audit failure were discussed in an audit committee meeting and, if they were, why the follow-up was inadequate.

If a PCAOB review or an investigation of an audit failure indicates that an audit partner or firm was, in fact, “too close” to a client and, as a result, permitted inappropriate accounting or reporting, PCAOB should be able to then mandate that the company choose another accounting firm.

One more matter. Firms have been criticized for writing that they “partner” with a client to achieve the client goals. I submit that the real meaning of that inartfully worded statement is far from an exhibition of a lack of independence. My experience is that what is meant by that statement is that the audit firm with work with the client to achieve the desired result if that is possible to achieve within the rules. An analogy might be helpful. A traffic cop “partners” with a blind person in helping that person cross the street legally by directing him to a cross walk rather than letting him jay walk in mid-block.

I would be please to discuss any of the matters raised in my letter with you.

Sincerely,

Arthur L. Ruffing, Jr.