





Rotation Of Auditor

On 2 June 2017, The South African Independent Regulatory Board for Auditors (IRBA) issued a Rule prescribing that auditors of public interest entities (PIEs) must comply with Mandatory Audit Firm Rotation (MAFR) with effect from 1 April 2023.

The New Rule stipulates that auditors can now only serve for a maximum of 10 years, after which they have to

rotate off the client for a cooling off period of 5 years, before being eligible to be appointed as the auditor of the client again.

Needless to say, this has caused quite a furore in the accounting community especially with the Big 4 firms as they have serviced some clients for uninterrupted periods, in some instances exceeding a 100 years. The MAFR stands to disrupt these long-standing relationships.

Before we introspect the merits of MAFR in the South African context, it is important to get some background on the origins of MAFR. The global financial crisis brought to the fore questions surrounding the scope and quality of external audit, market concentration and auditor independence. The crisis reopened concerns about auditor tenure and its consequences for auditor independence and audit quality. More specifically, regulators expressed concerns that the desire to retain clients and the familiarity created between auditors and management might over time impair auditor independence, which in turn could adversely affect audit quality. This resulted in a global debate on how best to address the issue. After a series of deliberations, discussions and inputs from industry and the accounting fraternity, there was no clear consensus on the way forward.

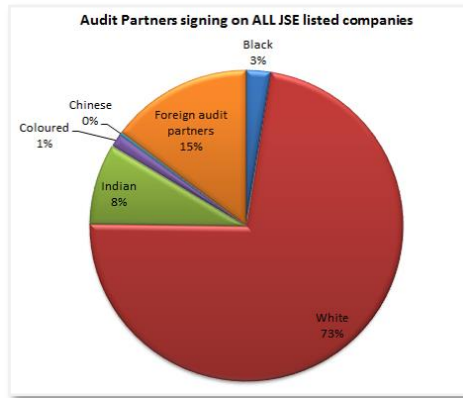
The two most notable regulators in the world, namely the European Commission and the regulator in the United States, embarked on very different paths in their quest to achieve auditor independence. The EU, after having implemented partner rotation in 2006, decided in 2014 to adopt MAFR at 10 to 24 year intervals, depending on certain criteria. The US implemented mandatory partner rotation in 2002 through the Sarbanes-Oxley Act, but decided, after involving academics and public hearings, not to introduce the rule at the audit firm level, at least for now.



Coming back to the South African context, what does the IRBA aim to achieve with the introduction of MAFR? It seems that South Africa's intention has been to respond to the current global trends and recent international legislative measures which have been implemented in respect of strengthening auditor independence. However, IRBA's considerations are broader and pertain to the following three objectives:

- To strengthen auditor independence and thus protect the public and investors, which is part of the regulator’s strategy;
- To address market concentration of audit services and create a more competitive environment, which will positively influence audit quality; and
- To promote transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets, provided they are competent to audit in those markets.

These three objectives set out above do make the South African debate around MAFR somewhat different to the international debate.



“Our latest inspection findings include independence issues as one of the top five findings amongst the audits of financial statements. This is consistent with global inspections results. In a South African context, the IRBA Board has also recognised the challenges with lack of economic transformation, and domination by certain firms within the profession. Out of the 353 audit partners who sign off on the financial statements of all JSE listed companies, only nine are Black African and over 90% are audited by a few firms. We will only see true

empowerment when opportunities are provided equally amongst everyone,” says IRBA CEO, Bernard Agulhas.

While these seem to be sound and reasonable objectives it has been met with opposition from certain quarters of the accounting fraternity. The opponents claim that requiring companies to rotate their auditors would not provide any additional audit quality that was not already being provided by having lead audit partners rotate. They believe that the current 5 year rotation requirement of lead audit partners already captures all the benefits of mandatory audit-firm rotation in a cost-effective manner, including the important attribute of a fresh set of sceptical eyes.

This brings us to the next and one of the most widely discussed demerits of rotation, and probably one that affects the client the most, namely the cost benefit analysis. It is argued in certain quarters that the potential cost of mandatory audit firm rotation exceeds its benefits. One cannot deny that there are set-up costs for the new auditors to obtain an understanding of the client's business model and organisational structure, as well as costs for the client's management to support the new auditors in these learning procedures, is a major concern, especially amongst the larger and more complex multinational JSE listed companies. Changing the auditor results in, among other things, organisational disruptions, start-up costs, increased need to compete for expensive tenders, loss of client-specific knowledge and the ability of the audit client to negotiate on audit fees.



Another concern is that the likelihood of audit failures might be greater in the initial period of an auditor-client relationship because of the lack of auditor knowledge about client-specific risks, processes and operations. If an audit firm is familiar with an organisation, it knows what reports to ask for and where to get them. It also learns the company’s terminology, which streamlines the audit process. Auditors can be more effective after they have gone through a couple of audit cycles because they have institutional knowledge. It is argued that an increase in audit tenure, builds company-specific expertise which allows auditors to rely even less on management and therefore become more, rather than less, independent.



Finally firms would need to guard against a decline in investment in people and innovation, especially in key specialist areas. If one is forced to rotate, and assuming this work is not satisfactorily replaced for that sector, it would be difficult to continue to support the desired levels of

investment to continuously build intellectual property. Another disadvantage is the loss of institutional knowledge that extends to the full team. As a result, auditors are concerned about an increase in uncertainty regarding audit capacity needs and how and where to best locate talented employees with particular skill sets. In addition, there is also a danger that important longer-term investments in the development of specialised knowledge will potentially be avoided and that mandatory firm rotation might create a disincentive for audit firms to acquire specialisation because they will not be able to target specific client segments anymore.

The Regulator’s main concern about audit firm tenure is about a potential decrease in auditor independence and hence audit quality as a result of an overly tight relationship between auditor and client. The argument is that excessive familiarity with the client’s management together with the pressure to retain the client may lead to an eagerness to please the client and a lack of attention to detail. By minimising the maximum length of tenure, it is argued that auditors will be forced to pay closer attention to the details and be more sceptical in their audit approach. Auditors are supposed to be independent of their clients, closely scrutinising their operations. The proponents to MAFR argue that if the auditor is with the same client for too long, they may lose objectivity and won’t ask hard questions.

Also, the threat of routine, as reflected in excessive reliance on prior-year working papers is frequently mentioned as a drawback of tenure. It can potentially result in insufficient audit procedures and excessive reliance on static audit programs and prior year results. If the auditor has always tested an account balance a certain way, then he or she may continue to do so — even if it’s no longer the best method. This can result in a potential decrease in independence and scepticism and erosion of audit quality. MAFR rotation is aimed at increasing audit quality because it necessitates potential mitigation from such independence and routine threats.

Second, and related to the first argument, is an expected positive effect of mandatory audit firm rotation on auditor ‘independence in appearance’. In other words, according to this argument, financial statement users will perceive the

auditor to be more independent after mandatory rotation, which will benefit perceptions of the financial statement and market reactions as a whole.

While we all agree that every auditor should be independent and conduct an independent audit, are we certain about what it actually means for the auditor to be independent? According to Dopuch, King and Schwartz (2003) there are two aspects of auditor independence, independence in fact and independence in appearance. Independence in fact (real independence) is related to the auditor’s ability to express an opinion about the financial statements without his or her professional judgement being affected by factors which could negatively affect his or her integrity, objectivity or professional scepticism. The auditor with independence in fact would make the audit as correct as possible. The independence in appearance (perceived independence) is related to a third party. If the auditor is not perceived as independent by the users, the auditor is not seemingly independent. Studies have concluded that auditor’s independence in appearance is viewed, especially among investors, as a pre-requisite for audit quality. Together these two aspects of auditor independence are essential to achieve the goals of auditor independence.

Auditors Independence



The mandatory rotation of audit firms is applicable on public interest entities. It is of importance to highlight the role of the investors in these companies, because the characteristic of these companies is the fact that the ownership is often separated from the management. The investors must therefore rely on the information given in financial reports by the management, the auditor aids to increase the credibility of the reports. Hence it is of paramount importance that independence in appearance also be

given due consideration. The lack of independence in appearance is enough to undermine confidence in the audit and financial reporting, and potentially lead to the destabilisation of markets.

A third argument in favour of mandatory rotation is that it might provide smaller audit firms the opportunity to participate due to increasing market competition. This brings us back to the IRBA’s intention to pursue the three objectives with MAFR to improve transformation and competition in the auditing industry. While the cause is noble, the question is, is it achievable? The obvious doubt on the matter is whether a smaller audit firm, possesses the resources, international presence or the experience, to service large, complex, and global clients. Some mid-tier firms insist that a lot of second tier firms have the capability to audit JSE-listed companies but are not getting the opportunities due to longstanding relationships held by the Big 4. So what can be wrong in trying to create a levelled playfield? The client ultimately decides through its audit committee which firm is best suited for its needs, and if MAFR provides a window of opportunity for smaller firms then ultimately it is improving the standard of the auditing community as a whole.

Obviously the smaller firms must make the investment to gear up their resources and probably deal with issue of the lack of experience through Joint Audits, a consideration that IRBA should look into seriously before 2023. But with 6 years to go before the MAFR Rule comes into effect the auditing industry needs to reflect on 'invest in moving forward or risk being left behind'.



While everyone welcomes changes that are aimed at improving the relevance and quality of audits and the promotion of sound capital markets and investor protection, there is disagreement on how this can be achieved. The opponents argue that the requirement of the Companies Act for mandatory audit partner rotation, a world-recognised Corporate Governance framework in King IV, and the new addition to the Auditor's Report namely Key Audit Matters sufficiently addresses the issues.

The added cost to the economy as a result of mandatory audit firm rotation cannot be ignored, but if it results in improving the competency, confidence and propriety of the profession it is a cost worth bearing. While mandatory audit firm rotation will address the independence concern, it might not immediately address the need to broaden capacity and increase access to opportunity, although these outcomes could be advanced in the long term.

The rotation debate has always centred on a key question: what would make for more effective audits, a fresh pair of eyes (a new accounting firm) or deep — but perhaps compromised knowledge about the ins and outs of a complex company? Only time will tell if MAFR indeed achieves its objectives. In the meantime, it is worthwhile to note that South Africa is ranked number one in the world by the World Economic Forum for the strength of its auditing standards and has held this ranking for seven consecutive years. It is imperative that we continue to improve, invent and lead on standards and measures to protect investors in order to retain confidence in the credibility of our financial markets.

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