AUDITOR ROTATION – A CRITICAL AND COMPARATIVE ANALYSIS

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The present paper starts out from the challenge regarding auditor tenure launched in 2010 by the Green Paper of the European Commission "Audit Policy: Lessons from the Crisis". According to this document, the European Commission speaks both in favor of the mandatory rotation of the audit firm, and in favor of the mandatory rotation of audit partners. Rotation is considered a solution to mitigate threats to independence generated by familiarity, intimidation and self-interest in the context of a long-term audit-client relationship. At international level, there are several studies on auditor rotation, both empirical (e.g. Lu and Sivaramakrishnan, 2009, Li, 2010, Kaplan and Mauldin, 2008, Jackson et al., 2008) and normative in nature (e.g. Marten et al., 2007, Müller, 2006 and Gelter, 2004). The objective of the present paper is to perform a critical and comparative analysis of the regulations on internal and external rotation in force at international level, in the European Union and in the United States of America. Moreover, arguments both in favor and against mandatory rotation are brought into discussion. With regard to the research design, the paper has a normative approach. The main findings are first of all that by comparison, all regulatory authorities require internal rotation at least in the case of public interest entities, while the external rotation is not in the focus of the regulators. In general, the most strict and detailed requirements are those issued by the Securities and Exchange Commission from the United States of America. Second of all, in favor of mandatory rotation speaks the fact that the auditor becomes less resilient in case of divergence of opinions between him and company management, less stimulated to follow his own interest, and more scrupulous in conducting the audit. However, mandatory rotation may also have negative consequences, thus the debate on the opportunity of this regulatory measure remains open-ended.
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1. Introduction

The Green Paper of the European Commission issued on the 13th of October 2010 "Audit Policy: Lessons from the Crisis" launches a number of 38 questions, among which one regarding the long-term audit-client relationship: „From the viewpoint of enhancing the structure of audit markets, do you agree to mandatory rotation and tendering after a fixed period? What should be the length of such a period?" The European Commission speaks both in favor of mandatory firm rotation, and in favor of the mandatory rotation of audit partners, for the benefit of objectivity and dynamism on the audit market. Starting from this issue re-launched by the European Commission, authors considered appropriate the critical and comparative analysis of the normative framework on auditor rotation at European, international and North-American level. The paper is structured as follows: first of all, the most relevant previous studies on auditor rotation are analyzed; second of all, the research design is explained; third of all, the relevant regulations to be found at European, international, and North-American level are presented, while in the last section of the paper, authors analyze critically and by comparison the identified regulations and present arguments against and in favor of mandatory auditor rotation.

2. Literature review

Numerous studies on auditor rotation have been recently carried out. For instance, Lu and Sivaramakrishnan (2009) investigate the effects of mandatory audit firm rotation on companies' investment decision and auditor choice in a capital market setting. Li (2010) tests the association between auditor tenure and conservatism and concludes that tenure imposes threat to auditor independence especially in smaller firms or firms weakly monitored by their auditors. Kaplan and Mauldin (2008) examine by experiments the impact of audit firm versus partner rotation on non-professional investors' independence-related perceptions. Their main conclusion is that by comparison with audit partner rotation, audit firm rotation does not strengthen independence in appearance among non-professional investors. Another study recently performed in Australia by Jackson et al. (2008) reaches the same conclusion, namely that mandatory firm rotation is not to be desired, because it does not enhance independence and audit quality. These studies are empirical in nature, but other researchers chose a normative approach, such as Marten et al. (2007), Müller (2006) and Gelter (2004), who investigate auditor independence regulated at international, European and North-American level, inclusively aspects regarding the auditor rotation.

3. Research design

The present paper has a normative research approach. The normative endeavor requires the analysis, explanation, and improvement of existing norms, as well as the development of new norms (Ionaşcu, I., 2007). The contribution to knowledge brought by this type of endeavor is validated by the acceptance of the interested parties (in case of auditing, the Chamber of Financial Auditors of Romania, audit companies, other accounting professionals, public interest entities, national and private companies, academic environment etc.). In the spirit of the normative approach, authors perform a comparative analysis of the regulation existing at European, international and US level with regard to auditor rotation. The relevant regulations are identified and their divergent and common points are analyzed. Moreover, the initiative of the regulator to introduce rotation is justified from the perspective of the role rotation plays in safeguarding auditor independence.

4. Normative framework regarding the internal and external auditor rotation

4.1. EU Regulations

Article 42 (2) of the Directive 43/2006 require the Member States to ensure that the statutory auditor or the key audit partner(s) responsible for carrying out a statutory audit rotate(s) from the audit engagement within a maximum period of seven years from the date of appointment. Their participating again in the audit of the entity is allowed after a period of at least two years. In the particular case of the auditors of public interest entities, the Directive requires internal mandatory rotation, namely the rotation of the key partner(s) that audit(s) such entities. Member States shall allow the audit firm to continue to be the statutory auditor of that entity, on the condition they impose the change of the key audit partner(s) who is/are associated with that firm.

Initially, the proposal for amending the Directives 78/660/CEE and 83/349/CEE published in 2004 set a rotation interval of maximum five years for the key audit partner responsible for carrying out the statutory audit. Moreover, it was proposed that the statutory auditor or the key audit partner responsible for carrying out the statutory audit on behalf of the audit firm is bound from taking up a key management position in the audited entity before a period of at least two years has elapsed since he resigned from the audit engagement.

The Recommendation of the Commission from May 2002 specifies internal rotation as safeguard to reduce independence risk if the collaboration of the key personnel with the client company is

long enough to create familiarity or trust. It is even stated that in order to mitigate familiarity or trust threats to independence, the rotation of the engagement partner or other key audit partners of the engagement team within a reasonable period of time cannot be replaced by other safeguards.
However, the European Commission admits that in certain situations, the internal rotation of the engagement partner and of other key partners is not possbile, due to the size of the audit firm. This is the case of a sole practitioner's practice or of an audit office where the daily relationship between a limited number of Audit Partners is too close. In such situations, other safeguards are to be implemented within a reasonable period of time. If no appropriate safeguards can be identified, the statutory auditor should consider whether he/she should continue the audit engagement.
At the level of the European Union, the mandatory internal rotation alone is stipulated as safeguard to ensure independence. However, the Directive 43/2006 mentions in case of auditing public interest entities the possibility that a Member State requires the change of the audit firm also, if that state considers it appropriate for achieving the set objectives. Therefore, if the client company is a public interest entity, the solution of the external rotation is alternatively regulated.
Recently, the Green Paper of the European Commission issued on the 13th of October 2010 "Audit Policy: Lessons from the Crisis" states that the periodical rotation of key audit partners in accordance with the 8th Directive does not suffice for completely eliminating familiarity threats. This is the reason why the European Commission suggests to consider the mandatory rotation of audit firms and not only the rotation of the audit partners. In order for this measure to really be efficient, it is considered necessary that regulations on rotation, if adopted, to clearly stipulate the compulsoriness of rotating both firms and partners. Such regulations would thus prevent partners changing audit firms only to "take along" certain clients.

4.2. International Regulations

The IFAC Code of Ethics (IFAC – International Federation of Accountants) does not comprise regulations regarding the external rotation of the audit firm, but mentions only the internal rotation as safeguard in relation to the threats posed to independence by self-interest and familiarity. In the general case, the rotation of the senior personnel of the engagement team is a possible solution to reduce the risk of such threats (paragraph. 290.150, 2010). In the particular case of public interest entities, the key audit partner should be replaced after seven years the latest. Only after a period of two years, in which the individual shall not be a member of the engagement team or be a key audit partner, that person can be again involved in the audit process of that entity (paragraph. 290.151, 2010).
The IFAC Code of Ethics also mentions situations that do not allow following these periods. For instance, it is permitted for key audit partners to continue to be part of the engagement team, if their involvement is particularly important to audit quality and if unforeseen circumstances outside the firm's control take place, which prevent internal rotation. In such a situation, it is necessary that the threat to independence is or reduced to an acceptable level by applying appropriate safeguards (paragraph 290.152, 2010).
Another situation regulated by the IFAC Code of Ethics in paragraph 290.154 is when an audit client becomes a public interest entity at a certain point during the collaboration with the auditor. In this circumstance, when determining the timing of the rotation, one should consider the length of time the key audit partner has been involved in auditing that entity. If when the client becomes a public interest entity, that individual was a key audit partner for five years or less, he may continue to serve the client in that capacity for seven years less the period of time already served. If that person served as key audit partner for six or more years, he/she may serve as audit partner for a maximum of two additional years before being replaced.

It may also happen that internal rotation of key audit partners is not an achievable independence safeguard due to the limited number of persons within the audit firm who have the necessary knowledge and experience to serve as a key audit partner. In such a case, paragraph 290.155 of the IFAC Code of Ethics stipulates that if a an independent regulator in the relevant jurisdiction has provided an exemption from partner rotation in such circumstances, it is allowed that an individual remains a key audit partner for more than seven years, provided that the independent regulator has specified alternative safeguards (such as an independent external review).

4.3. US Regulations

In the United States of America, mandatory external rotation was in the focus of US regulatory authorities, as shown by the study of the General Accounting Office carried out in 2003 and required by Section 207 of the Sarbanes-Oxley Act (SOA) for analyzing the costs and benefits of such a legislative measure. However, there are detailed regulations only with regard to internal auditor rotation.

The Code of Professional Conduct of the American Institute of Certified Public Accountants (AICPA) mentions in paragraph ET §100-1.26 (r) as example of safeguards implemented by the firm the rotation of senior personnel who are part of the attest engagement team. Section 203 SOA, subsection (j) is more specific, since it regulates the mandatory internal rotation after five years. A firm is not allowed to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that entity in each of the 5 previous fiscal years of that entity.

The regulations of the Securities and Exchange Commission (SEC) on partner rotation (namely CFR § 210.2-01 section (6)) are quite detailed. Any audit partner who performs the services of a lead partner or concurring partner for more than five consecutive years is not considered to be independent. A period of maximum seven consecutive years is foreseen by SEC for (1) providing more than ten hours of audit, review, or attest services in connection with the annual or interim consolidated financial statements of the issuer; (2) serving as the lead partner or concurring partner in connection with any audit or review related to the annual or interim financial statements of a subsidiary of the issuer whose assets or revenues constitute 20% or more of the assets or revenues of the issuer's respective consolidated assets or revenues. CFR § 210.2-01 also establishes a cooling-off period of five consecutive years, over which that partner is not allowed to serve as lead partner or concurring partner or a combination of these. For the other services which can be carried out for a maximum period of seven consecutive years, the cooling-off period is of only two years.

An exemption from these rules regarding internal rotation is stipulated for audit firms with less than five clients that are issuers and less than ten partners, on the condition that PCAOB (Public Company Accounting Oversight Board) conducts a review at least once every three years of each of the audit client engagements that would result in a lack of auditor independence because of the prolonged period of collaboration of the auditor with a certain client.

5. Critical and comparative analysis

By comparison, the regulation authorities at all levels (international, European and North-American) require the internal rotation at least in the case of public interest entities, while the external rotation is not to be found in the center of the attention of the regulators. The most strict and detailed requirements are those issued by SEC. They stipulate the rotation of the lead partner and concurring partner after a period of five consecutive years, while being prevented for other five years to serve that client. According to the regulations at European level, the partner can be responsible for the statutory audit at a certain client for at least seven years from the appointment

date, period after which their participation in auditing the entity after a time frame of two years is allowed. In this respect, the European regulations are identical with those available at international level. Another common point between the European and the international regulations is represented by the fact that both normative frameworks consider the possibility that the requirement of the internal rotation cannot be followed due to the size of the audit firm.

The purpose of the regulations on internal, namely external auditor rotation reside in the wish of the regulator to protect auditor independence from the familiarity threat. Familiarity and trust in the client-company are caused by a long-term relationship between the financial auditor and the audited entity. Such a relationship over several years leads to a relationship of trust between the two parties. Therefore, it is possible that because of familiarity, auditor independence is threatened, because his/her objectivity is compromised, and he/she is not able anymore to identify some relevant aspects for the audit opinion which would normally came out.

Other independence risks in this context are those generated by self-interest and intimidation. Financial auditors can be considered economic agents, whose decisions are driven by their own interests. If reporting an error is correlated with the decrease of the turnover, their availability to report that error decreases. Moreover, if an audit contract is not prolonged the auditor loses future economic advantages (quasi-rents according to DeAngelo, 1981). The client can exert pressure over the auditor by threatening he will not prolong the audit contract and thus auditor independence can be compromised. External rotation is an independence safeguard for these threats posed by self-interest and intimidation. If external rotation were mandatory, according to Marten et al. (2007), the auditor will be much less capable of facing eventual pressures from the client, and not prolonging the contract will have reduced economic consequences.

On the other hand, one can argue that a long-term relationship between the financial auditor and the audited company is beneficial, because the auditor, due to a thorough knowledge of that company and its activity, can perform a more efficient and more valuable audit. Moreover, the literature on the topic (see Müller, 2006) considers the efficiency of a first audit engagement is more reduced than the efficiency of subsequent audits. Moreover, the costs of the subsequent engagements are lower than the cost of the first engagement, because auditor's efforts of adapting and familiarizing with the processes and activities of the audited firm already have been made. Table 1 briefly presents the arguments for and against the compulsoriness of auditor rotation in accordance with the ideas of Marten et al. (2007) from the perspective of the influences it has on audit quality, understood by DeAngelo (1981) as the ability of the auditor to detect errors.

Table 2: Arguments for and agains the compulsoriness of auditor rotation

Arguments for	Arguments against
A long term relationship increases the risk that the auditor anticipates the results of the previous financial statements instead of identifying new changes in the audited firm.	The experience, the knowledge and the deep understanding of the structures of the audited company are lost.
The increased trust of the financial auditor in running the company makes him/her perform fewer audit procedures or to perform them less strict.	Since the new auditor must adapt to and get familiar with the client-company, there is the risk that in the first years of the engagement, he/she ignores some errors, because he/she does not know the client well enough.
If the auditor is convinced by the management's integrity, he/she will ignore errors, will overlook them or will	In the first audit engagements, the auditor is more dependent on the information provided by the client and it

underestimate them.	is more difficult to him/her to check their correctness.
In case of tenure, there is the risk that the auditor identifies with the problems of the management and does not act with professional skepticism anymore.	Rotation prevents the development of audit plans over several years.
By changing the auditor, there is more room for innovations in selecting and applying audit methods, while trust in management limits creativity.	Because not all areas can be intensively audited, there are some aspects which are not audited within the first engagements.
Audit procedures are more difficult to be foreseen by the client.	Auditors are less motivated to invest in resources specific to the client and its economic branch, because rotation reduces the economic life of such assets.
Aware by the fact that his/her activity might be checked by future auditors, the auditor will work more conscientiously.	Through rotation, the auditor is less motivated to invest in economy and efficiency (for instance in persons and in technological innovations).
Mandatory rotation increases competition on the audit market, because more audit engagements are available, which has a positive effect on audit quality.	The competitiveness incentives are lower, especially because efficient auditors do not receive the maximum possible profit from their engagements, since rotation temporally limits the demand for their audit services.

Made by the authors, in accordance with Marten et al. (2007)

6. Conclusions

Following the research performed, we can conclude that all the regulatory authorities, both the international and the European and North-American ones presented rotation as a solution to the threats generated by a long-term relationship between the financial auditor and the client company. Essential is the distinction between the internal rotation (of the persons involved in the audit and active in the mandated audit firm) and external rotation (of the audit firm). The internal rotation is stipulated by all the regulatory frameworks presented, while the external rotation, although over the years it was of interest for the legislators, is not regulated. The strictest regulations on internal rotation are those of the North-American space, which are also the most detailed ones. The European and international regulations overlap to a great extent.

Despite of the state of facts regarding the regulations, auditor rotation is still a debated topic. The critical analysis performed in this paper presented some of the arguments in favor of this solution, but also some of its possible undesired negative effects it may have. Thus, the mandatory rotation makes the auditor less resilient in case of divergent opinions between him and company management, less stimulated to follow his own interest, and more scrupulous in performing audit works, knowing his work will be controlled by the following auditor. On the other hand, by setting mandatory rotation, the knowledge and experience gathered over numerous audit engagements can be less capitalized, while the motivation to invest in resources that are specific to the client and its industry, and the incentives for competitiveness are lower. Thus, the debate on the opportunity of the rotation remains open-ended.

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