ROTATION AND INDEPENDENT FINANCIAL AUDIT

Assoc. Prof. Dr. Slavi Genov

Introduction

The question of auditors’ independence and the quality of audit services became particularly pressing in the USA in 2002 following Enron and WorldCom corporate scandals. Quality of audit services has been the focus of public attention in Bulgaria following the problems with Corporate Trade Bank (CTB).

While performing an independent financial audit, registered auditors adhere to ethical principles which determine their professional conduct and responsibilities. Among the most important principles are:

- independence – in material, personal or any other aspect registered auditors should be free from undue influences arising from their relationships with partners or members of staff and they should be free from any conflict of interest in relation to the organization that is subject to audit, its managers or any third parties.

- objectivity, lack of bias and non-admission of prejudice, conflict of interests or other influence which might impair the auditor’s professional judgement.

Rotation of auditors is a possible variant for achieving a higher degree of independence and objectivity.

This article aims to examine the connection between auditors’ rotation and independence and to evaluate the new regulations regarding audit practices within the European Union.

Rotation of the key audit partner according to Sarbanes-Oxley Act

The issue of auditor rotation gained particular relevance after the adoption of the Sarbanes-Oxley Act in the US in 2002, in response to the corporate accounting scandals at Enron and WorldCom. Two variants of rotation exist:

- rotation of key partner auditor (the one responsible for the audit);
- rotation of the audit firm.


1 Member states guarantee that key partner/s auditors who are responsible for performing statutory audit, do fulfill their audit obligations in turn, for a maximum of 7 years from date of appointment and can be allowed to take part in audit of an auditee after a period of minimum two years.”
“The key partner auditor of an audit firm, as well as the auditor who works directly through an individual practice, and is responsible for auditing an enterprise whose activity is of public interest, should withdraw after 5 consecutive years of audit engagement from the date of appointment in the audit firm.” The above mentioned requirement applies to audit engagements regarding annual financial statements prepared after 31 December 2008.” (Act of amendment and supplementation the Independent Financial Audit Act, par. 27 from Transitional provisions) i.e. the first rotation period expires with the audit for the year 2013. /see Position of UMS - ICPA/

The law only regulates the key partner auditor rotation. The issue of audit firm rotation remains unresolved.

**Rotation rules in Germany**

There are similar rotation rules in other European states as well. A more detailed examination of the German legal framework shows some differences. According to the Commercial Act in Germany (Handelsgesetzbuch HGB) an auditor has no right to assume responsibility for more than seven cases of auditing public interest enterprises (“in sieben oder mehr Fällen”) unless two years have passed since the last audit. (HGB, 2014). The Seven Occasions formulation has resulted in a number of ambiguities in the German audit practice, as it doesn’t specifically clarify the point whether assuming audit responsibility for the individual statement and the consolidated statement of one and the same company (the parent company) should count as two separate cases of assuming audit responsibility. As a result, the Bundestag Council (Bundesrat) has come up with a decision, according to which Germany will apply the European practice and seven consecutive years will be meant under the wording “7 occasions”.

**Critical analysis of the opinions regarding rotation**

Regarding the compulsory rotation of the key partner auditor (the one in charge of the audit) there usually is consensus and most authors accept the necessity of this type of rotation.

It is important to point out that there isn’t a unanimous opinion regarding audit firm rotation. According to some authors this rotation should be compulsory to perform, as key partner auditors follow the procedures and policies of the audit firm and can be subjected to its pressure (to the detriment of independence). In this connection the basic theses can be grouped as follows:

- Rotation improves the quality of audit services and results in reducing audit risk.
- Periodical change of auditors limits familiarity between auditors and client’s employees, which leads to greater independence.
- A prerequisite for enhancing audit quality is the opportunity of a “new and fresh view” over the client’s financial statements, as well as the fact that the next auditor will detect the previous auditor’s mistakes.
- Compulsory rotation will enhance the quality of audit services by increasing competition.
There is another group of authors who believe that compulsory rotation is not necessary, as restricting the tenure of key partner auditors / without a change of audit firm / achieves a great number of the benefits and at no extra costs.

American Institute of Certified Public Accountants (AICPA) is also against audit firm rotation. AICPA’s major arguments against compulsory rotation are based on the opinion that rotation:

- Increases audit costs and resources, which is only logical, as first time audit requires considerably more time to gain understanding of the audited organization while this knowledge and understanding have already been accumulated by the previous auditor;
- Limits institutional specialization and experience and results in lowering audit quality and increasing auditor’s mistakes;
- Decreases the stimuli for enhancing audit effectiveness and quality. Typically auditors aim to improve effectiveness and quality so that they keep their clients for a longer time, while with compulsory rotation this stimulus is of less importance;
- Poses difficulties concerning completing the audit in due time;
- Undermines the role of audit committees. (AICPA Letter, 2011)

Broadly speaking, according to AICPA compulsory rotation increases costs and lowers quality and existing regulations are good enough to ensure the necessary independence.

According to opponents of rotation, the independence of audit firms is achieved through the requirements of audit committees, public supervision, key partner auditors and limiting the non-audit services previously introduced. Therefore, in their view, a rotation of audit firms is unnecessary.

Another contentious issue concerning audit services is competition. Supporters of rotation assume that competition enhances audit quality. According to opponents of rotation, however, growing competition does not result in improvement, but rather in a drop of auditors’ remuneration, which is a serious prerequisite for a drop in audit quality.

We are right then to claim that the arguments presented for and against compulsory rotation are not unambiguous. They can be interpreted differently. Therefore, it is suitable to perform this study on the basis of the existing practice in countries that have adopted rotation rules.

**Current development of Rotation rules**

In view of achieving greater effectiveness, efficiency, objectivity and independence, on 17 June 2014 the reviewed directive and regulations concerning audit reform came in force in the EU. These affect Public Interest Entities (PIEs). Division of audit and consultancy services is envisaged (black list). Auditor companies market (Wirtschaftsprüfungsgesellschaften) is expected to get reshuffled over the next few years.² (Reu , 2014).

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² The statement is valid for Germany mostly.
On October 13, 2010 the Green Paper on Audit Policy was published by Commissioner Barnier, under the title “Audit Policy: Lessons from the Crisis”. After a process of intensive consultations in November 2011 the European Commission adopted two legislative proposals: regulations “concerning specific requirements for compulsory audit of public interest entities” and a directive for amendment of the current Directive regarding compulsory audit of annual financial statements and consolidated annual financial statements. After a lengthy process of negotiations, on 17 December 2013 a compromise was reached among the EU legislative bodies, the European Parliament, the EU member states and the EU Commission. On 21 January 2014 the European Parliament adopted the final regulation and directive. At the European Parliament plenary meeting on 03 April 2014 and at the Council of Ministers on 14 April 2014 the respective texts were adopted. Adopted regulations are to come in force 20 days after they have been published in the Official Journal of the EU – 27 May 2014, so the date they come into force is 16 June 2014. After the directive comes into effect, it is to be adopted by the national legislation as well.

“The regulation is jointly adopted by the Council of the European Union and the European Parliament, or only by the European Commission and by nature it is a general Act that is binding in its entirety. Unlike the directives, which are addressed at member states, and the decisions which have a clear addressee, regulations refer to all. They are directly applied i.e. they create legislation to be applied directly in all member states like national laws and no further measures need to be taken by national governments”. (European Commission, 2014).

A European directive may be addressed to one, several or all of the member states and the objectives it determines must be achieved through means chosen by the respective state. The principles set forth in the regulation produce action in respect of nationals only after the national legislative bodies adopt an act of the regulation’s transposition into national law. In this way national laws adapt to the objectives determined by the directive.

It is envisaged “a deadline for transposition into national legislation: member states have a degree of freedom of action regarding the deadline, which allows them to take national specifics into consideration. Transposition should be executed within the time frame stipulated in the directive.” (European Commission, 2014).

The directive must be applied no later than 16 June 2016. In case of delay or incomplete transposition, a penalty procedure for infringement may start. Provisions of the regulation are in force as of the date of coming in force, i.e. 16 June 2014.

The basic changes in the existing directive regarding compulsory audit refer to:

• Cancellation of the member states right of choice to limit the definition of public interest entities (Public Interest Entities, PIE) to publicly traded companies;
• Amendment and extension of the regulations for creating audit committees and the tasks of public interest entities;
• Adjustments to the rules of auditor objectivity and professional independence, as well as of the overall organization of auditors and audit activities;
Quality assurance systems and a number of detailed requirements for auditors sanctioning;
A new mechanism for adopting International Standards on Auditing in the European Union;
Publishing audit results and subsequent reports for internal audit committees.

The key provisions of the Regulation apply to the compulsory audit of public interest entities. Major areas concern:
- restricting non-audit services while auditing public interest entities, in particular, adopting a black list of non-audit related services;
- initial introduction and regulation of compulsory rotation, as well as a detailed description of the process of selecting an auditor;
- professional supervision over statutory auditors and audit firms by European bodies;
- Setting up a new oversight body – European Audit Oversight Board (a body with a wide range of authority).

The new rules for compulsory rotation

Under Article17 of the Regulations, it is a basic rule that public interest entities must change their auditors after a maximum of 10 years. Yet member states can shorten this period of rotation. Companies can also choose a longer cycle of rotation than that of the basic rule depending on the respective decision of the member states about the application of the basic rule.

According to the Regulations, in any member state the 10 year period can be:
- extended to a maximum of 20 years, if, after the first 10 years of audit, a public tendering of audit contracts is performed;
- extended to a maximum of 24 years, if, after the first 10 years, more auditors (for example within the Joint Audit framework) perform the audit.

There are special transitional rules about the compulsory rotation. According to the text of the regulation, they will have the following effect:
- If on 16 June 2014 an auditor has been a public interest entity auditor for more than 20 years, the company should change the auditor in 6 years, that is the deadline for the first compulsory rotation expires on 16 June 2020 and as a result, this auditor cannot be chosen again after 16 June 2020.
- If by 16 June 2014 an auditor has performed audits for 11 years or more, but fewer than 20 years, the company must change the present auditor after no later than nine years, that is, the first compulsory rotation ends on 16 June 2023 and, as a result this auditor can no longer be chosen again after 16 June 2023.
- For cases where on 16 June 2014 an auditor has been performing audits of public interest entities for fewer than 11 years, there are no special transitional rules; Regulations of general rules of rotation is applied. (Deloitte, 2014)

Research on the biggest German companies on the stock exchange shows that by 31 December 2012, 24 out of the 30 DAX companies have been assigning their
In 2020 at the latest, these companies must perform a rotation. (ReuJ, 2014). The introduction of internal rotation is expected to result in restructuring of the audit services market in Germany. A similar research on audit practice in Bulgaria is not available. Therefore no conclusions can be drawn about the consequences of introducing external rotation on the audit services market in Bulgaria.

Another substantial question is whether external rotation eliminates the obligation of key partner auditor rotation.

Along with compulsory rotation of auditors, there remains the problem with changing the key partner auditor after a maximum of 7 years. The two-year cooling off period between dismissing an employee and hiring him/her again is extended to three years.

In our opinion, rotation is unquestionably one of the important elements for ensuring auditors independence and, consequently, rotation is important for audit service quality.

Regarding the compulsory rotation of key partner auditor, we accept it as necessary, because it provides a “new and fresh view” on the financial statement, but it cannot fully guarantee independence, as dependence is available in the framework of the policies adopted by the audit firm.

Rotation of audit firms has both positive and negative aspects. The most significant advantages are that it leads to reducing auditors risk, limits familiarity between auditors and client’s employees and improves the quality of auditor’s service. As disadvantages we can point out the following: increasing the audit-related costs, limiting institutional specialization and experience, increasing auditor’s mistakes, wasting understanding and knowledge of the business entity that had been accumulated, reducing the stimuli for enhancing audit effectiveness and quality and the chances of the audit being completed in time.

Taking into considerations the above mentioned positives and negatives and the national practice so far, we believe that concerning rotation, Bulgaria will benefit most from the following statutory regulations under article 17 from the Regulations:

1. Public interest entities must change their auditors after a maximum of 10 years, and the rule of changing the audit firm should be retained; or
2. Having in mind the economic crisis and the economic environment in the country: public interest entities must change their auditors after a maximum of 5 years and the rule of changing key auditor partner should be retained. Companies may also choose a longer rotation cycle but not one longer than 10 years and on condition that a Joint Audit is performed in the fifth year of the audit engagement.

**Conclusion**

Introducing external rotation aims to counteract the danger of familiarity or market concentration. Nevertheless, compulsory external rotation does not directly result in assigning audit responsibilities to audit firms other than the Big Four. Another debatable issue is whether external rotation results in a better audit quality or, rather, it contributes...
to loss of valuable knowledge of the audited company and its structures (Wissenslücken). To achieve the goal of opening the audit services market and limit loss of knowledge, attention should be paid to external rotation combined with Joint Audit. (Datev, 2014) In this connection two possible solutions are suggested for Bulgaria:

- Public interest entities have to change their auditors after a maximum of 10 years. Or,
- Public interest entities should change their auditors after either a maximum of 5 years or a longer rotation cycle, but no longer than 10 years, on condition that on the fifth year of the audit engagement a Joint Audit is performed.
- Rules of changing key partner auditor are retained.

Bibliography

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Abstract

Rotation is a means for ensuring independence in performing financial audit and is a fairly debated theme in EU countries. There are presented the rules on rotation in Bulgaria and are discussed arguments pro and con its introduction for the audit firms. There are summed up the most topical changes in this respect, in view of the fact that after 2016 it is for the first time that there is to be conducted a rotation of these enterprises within the EU. There are proposed the possible scenarios - according to the author - for the change of the auditor-in-charge and the rotation of audit firms.

Keywords: independent financial audit, rotation, directive, regulation.