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Mandatory Audit Firm Rotation



Registered Auditors | Accountants | Advisors

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Introduction



Nkonki supports the implementation of Mandatory Audit Firm Rotation (MAFR).



Nkonki considers the development of this requirement to be in the public interest as it aims to improve the protection of the investing public from potential audit failures that might result in substantial financial losses for investors.



In addition Nkonki believe that MAFR will have a large impact in the small to medium audit firm market which includes black audit firms.

Sello Hatang – CEO – Nelson Mandela Foundation – We have to take the growing discontent, in especially black communities, about the slow pace of transformation more seriously. The pedestrian pace of transformation is also evident in the business community, which goes largely untouched.



The Audit Process



- Audit process structurally flawed as it is reliant completely on humans who make mistakes.
 - The IRBA have cited many reasons for this. The most significant being:
 - Familiarity threat between CFOs and incumbent auditors.
 - Familiarity threat between audit committee chairs and incumbent auditors.
 - Long audit tenure of audit firms.
- Lack of auditor independence from the client firm is also a matter of concern. One suggested avenue to address these concerns is to place term limits by enforcing mandatory audit firm rotation (MAFR).
- These mistakes are costly (ENRON/MASTERBOND)
- Prior to accepting a client auditor must ensure that the members of the engagement team meet the relevant independence requirements.
 - Engagement team made up of partner and professional staff.
- Steps auditor follows during audit to maintain independence only based on individual honesty and integrity:
 - Declarations of any matters that impact independence.
 - Partner monitoring and concluding on independence.
 - Code of Professional Conduct which is principles based.



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The Audit Process



- No laws can control a person who has the intent of dishonesty or prepared to stretch the law to breaking point.
- To reduce familiarity threat (Relationships between auditors and their clients can create a closeness with management that may adversely affect the auditor's independence and reduce the reliability and quality of the audit).
 - The Wall Street Journal characterized one of these arguably "too-close" relationships as follows: "Andersen auditors and consultants were given permanent office space at Enron. They shared in office birthdays, frequented lunchtime parties... people just thought they were Enron employees" (Herrick and Barrionuevo, 2002). It is almost impossible for any legislation to control such behavior.
- Partner rotation introduced – but ignored the rest of the engagement team.
 - Partner despite signing audit report spends the least amount of time on audit.
 - By rotating partner the majority of the engagement team which comprise most of the familiarity threat have been forgotten.
- To eliminate familiarity threat means rotating the entire team – HENCE MANDATORY AUDITR FIRM ROTATION. (MAFR)
 - By rotating audit firm eliminating the human element completely .
 - The firm rotates no human element involved.
- Effective corporate governance measure – auditor has no incentive to bend rules to try and keep client.



Implementation Date



- Section 90 (2) (V) - a person who, at any time during the five financial years immediately preceding the date of appointment was doing consulting work cannot be appointed as an auditor. (5 year cooling off rule)
- As of 25 January 2016 many audit firms are engaged in various consulting engagements would preclude them from being appointed as auditors until 25 January 2021 (assuming they withdrew from this consulting work on the 25 January 2016).
- If the audit firm is given say 2 years to complete their current consulting engagement then the date MAFR can be implemented is 2023.
- If the audit firm is not engaged in any work as contemplated above the audit firm can be appointed immediately under s 90 of the 2008 Act.
- This would obviously benefit those audit firms who are currently not engaged in consulting work, which in essence will be most small to medium size audit firms (SME).
- Nkonki believe that 2023 favours the large audit firms and gives them an unfair competitive advantage by delaying implementation to 2023.
- The SMEs are being disadvantaged as they do not have access to consulting work for listed companies. Only by giving them immediate access to listed clients will the playing fields become level.



By Products



Although there are several thousand-audit firms existing in South Africa, only a few audit firms are appointed to audit listed companies. Moreover, these companies rarely switch from one audit firm to another so that audit firms have few opportunities to gain clients.



Only nine of the 353 audit partners who signed off on financial statements of JSE-listed companies were black African, and more than 90% were audited by a few firms.



If there is no MAFR to facilitate transfer of learning the auditing profession will never transform.



MAFR will have a large impact in the small to medium audit firm market which includes black audit firms – more opportunities.

- Audit market currently concentrated.



Bernard Agalhus - "We will only see true empowerment when opportunities are provided equally amongst everyone," If there is no mandatory joint audits to facilitate transfer of learning the auditing profession will never transform.



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Cost



- The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements.
- If auditors do not remain independent - impair audit quality.
- This lessens the confidence of the financial reporting process.
- The cost of this loss of confidence will be greater than any cost of MAFR which in essence is simply a mandatory change of auditors as opposed to a voluntary one.
- There appears to be no complaints when auditors in the normal course of events are replaced.
- Change of audit firms every five years is standard practice in the public sector and there appears to be no debate over the costs.
- The International Federation of Accountant's Financial Reporting Supply Chain Report notes: 'Although there are concerns about loss of valuable knowledge and experience, long lead times to get-up-to speed and more expensive audits, many respond that getting fresh eyes on the audit outweighs cost.'



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Conclusion



- Firm rotation can help restore confidence in the regulatory system, which was found to be the case in Italy.
- Further, if a client seeks a new auditor, auditors will compete with other audit firms to win the tender and differentiate themselves in terms of service, improving audit quality.
- Despite the increased start-up costs which are involved with introducing a new auditor, supporters of audit firm rotation propose that the costs of corporate collapses, which may not have occurred had audit quality been higher, outweigh the increase in audit costs involved when introducing a new auditor.
- From this perspective, a new auditor brings in more objectivity as they are not familiar with the client, potentially improving the quality of the audit.
- Mandatory rotation imposing a time limit on tenure would directly address the perception of an institutional familiarity threat.
- An auditor may be more focused on quality because their files will be reviewed by a successor auditor.
- A further argument in favour of MAFR is that it will prevent 'staleness' resulting from 'repetition of earlier [audit] engagements and will lead to improved audit quality and audit integrity, as rotation allows 'fresh eyes' to review the company's financial statements and accounting practices/policies as well as the previous firm's audit.
- Supporters argue that MAFR promotes diligence and conservative decision-making by auditors, as they will be aware, particularly towards the end of their term, that a new firm will be scrutinising their work with 'fresh eyes'.
- Clearly independence is not in good shape:
 - Accountancy firm Ernst & Young has agreed to pay \$9.3m to settle charges that two of its auditors formed "inappropriately close" relationships with staff at the companies whose books they were checking.



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