

## UNIVERSITY HONORS PROGRAM

### SENIOR PROJECT - APPROVAL

Name: Marquita Barton

College: Business Department: Accounting

Faculty Mentor: Jack Kiger

PROJECT TITLE: Analysis of the Mandatory Auditor  
Rotation Debate

I have reviewed this completed senior honors thesis with this student and certify that it is a project commensurate with honors level undergraduate research in this field.

Signed: Jack S. Kiger, Faculty Mentor

Date: 5-02-03

Comments (Optional):

Running head: Rotation

Analysis of the Mandatory Auditor Rotation Debate

Honors Senior Research Project

Marquita Barton

The University of Tennessee

## Abstract

Since the McKesson Robbins accounting scandal of the 1930s, the issue of requiring auditors to rotate their clients has continuously been debated. Many regulations are currently in place to promote the independence of auditors, but some believe that mandatory rotation is still necessary. The main arguments for mandatory rotation are more independent and quality audits and a fresher perspective, while the major arguments against rotation are increased costs and lower quality audits due to shorter engagements. Though Italy currently uses this policy and has faced several difficulties, the DuPont company successfully used mandatory rotation from the period of 1910 to 1954. After one analyzes all of the arguments and experiences with mandatory rotation, one should conclude that the policy should not be implemented.

With the recent audit failures of companies such as Enron and WorldCom, auditors and the accounting profession in general once again have come under much scrutiny. How is it possible that such vast misstatements of revenue and other items can occur in financial statements without any detection from the people paid to attest to these statements' validity? The frequency of these occurrences (approximately 233 companies have had to restate or correct earnings since 1998) has led to enraged outcries from the public for change in the form of more regulation (Kahn, 2002). One of the most controversial and longstanding issues in the pursuit of regulation is the subject of whether or not to implement mandatory rotation of auditors. This paper will discuss the history and arguments surrounding the debate and will determine whether or not the policy should be implemented.

Mandatory rotation, or auditor rotation, refers to the imposition of a limit on the number of years in which a particular audit firm may be the auditor of a particular corporation (United States, 2002, p.31). The most commonly suggested periods of rotation are five or seven years (Walker, Lewis, & Casterella 2001). Mandatory rotation is a controversial issue that has been debated for decades. The issue tends to resurface every time there is a major audit failure of a corporation.

### **The History of Mandatory Rotation**

Auditor rotation was first introduced during the McKesson Robbins hearings in the late 1930s ("Question", 1967, p.32). McKesson Robbins was involved in a huge scandal in which accounting firm Price Waterhouse failed to detect \$19 million in misstatements of inventory and receivables. McKesson Robbins falsified records, and Price Waterhouse did not question or verify the validity of their financial statements. What followed after the discovery of this fraud were congressional hearings and attempts by lawmakers to reform the accounting profession.

The result was the development of the first formal standards for auditing procedures (Ramos, 2002).

As additional scandals occurred, additional requirements were placed on auditors throughout the twentieth century. Recently, the Enron scandal and the subsequent audit failures involving other companies have again brought the accounting profession back under scrutiny and the issue of mandatory rotation back to surface.

The motivation behind auditor rotation is public concern over high profile corporate collapses (Catanach & Walker, 1999, p.48). In the age of the consumer, demands for public protection must be met. Whether or not the behavior of the accounting profession acknowledges it, the role of the independent auditor is to protect the public (Seidman, 1967, p.30). In an ideal setting auditors always model independent behavior. The public sees lengthy auditor-client relationships as a threat to the independence of the auditor. Regardless if these extended relationships are actually a threat to independence, the perception of independence is just as important as actual independence. In the public eye, what is a better way than to rotate auditors every few years to keep auditors independent? To a layperson, mandatory rotation, by limiting the client-auditor relationships in which the auditor loyalties may become divided, is a simple solution that will solve the problem of maintaining auditor independence. However, many do not understand all the issues and risks involved in implementing this regulation (Question, 1967, p.31), but before further discussing the implementation of mandatory rotation, it may be helpful to know the regulations already in place.

### **History of Accounting Regulation**

Traditionally, accounting has been a respected industry due to its ability to self-regulate. The start of self-regulation started with the creation of the Securities Exchange Commission in

by the Securities Acts of 1933 and 1934 (AICPA, Feb 2002). According to a statement issued by the American Institute of Certified Public Accountants (AICPA) in 1992 many regulatory factors, internal and external, help to ensure that public accounting firms remain objective, independent, and professional.

First, because of the work and time involved in developing a strong reputation, which is a CPA firm's greatest asset, no firm would deliberately jeopardize its reputation for a short-term gain. Moreover, individual professionals also recognize all that is at stake in their personal lives if they engage in unprofessional behavior. The amount of revenue generated from auditing also provides a strong incentive to firms to keep their practice trustworthy.

Another policy that serves to regulate accounting firms is the AICPA's quality control policy. All firms that are members of the Division of Firms in the AICPA must have a quality control system to protect audits and independence. This system and the firm's compliance with other professional standards must be reviewed every three years by another accounting firm.

Regulatory actions of the Securities and Exchange Commission (SEC) serve as the primary enforcer against all firms and individuals that have been found guilty of inadequate performance. The SEC also requires all registrants to report publicly all auditing and accounting disagreements when an auditor resigns or is removed. This measure was implemented to prevent companies from firing auditors simply because they would not compromise auditing standards.

The SEC Practice Section, which is a division of the AICPA, also has some regulations. Since 1990 if an auditor has a client that is a SEC registrant, then that auditor has to become part of the SEC Practice Section. The SEC Practice Section also implemented a partner rotation process, which requires the engagement partner responsible for the audit to rotate every seven

years. This purpose of rotating the partner is to offer a new perspective to audit engagements without the audit firm having to sacrifice the general knowledge learned about the client.

A final auditor regulation mentioned by the AICPA is the audit committee. Audit committees are composed of a company shareholders not associated with management. Their job is to check management to make sure that they serve in the public interest. The Statement on Auditing Standards No. 61 requires that auditors inform the audit committee of any significant disputes with management and whether the issues were resolved (AICPA, 1992).

### **The Newest Accounting Regulation: The Sarbanes-Oxley Act of 2002**

Despite all of these regulations and the accounting profession's continued assertion of its ability to self-regulate, auditing failures due to collusion of auditors and company management still persist. The inability of the accounting profession to come to a solution on its own to this problem has finally led to significant government intervention. In July of 2002, President Bush signed into law the Sarbanes-Oxley Act. According to the AICPA, this act will dramatically affect any auditor of a publicly held company (Aug 2002). Several significant regulations have been added that hopefully will allow accountants to regain the public's trust. However, the true impact of this new act will only be able to be determined once the SEC begins to interpret and enforce the new regulations.

The Sarbanes-Oxley Act created a new Public Company Accounting Oversight Board to investigate and oversee audits and impose sanctions for any violations. The "Board," as it will be referred to, will also regularly inspect the operations of registered accounting firms. The act charged the Board with setting standards for audit firm quality controls. The SEC will appoint and oversee the Board. It will be considered a nonprofit organization and a nongovernmental

agency. Public accounting firms must register with the Board and pay registration and annual fees (AICPA, Feb 2002).

In addition to forming a new oversight board, the Sarbanes-Oxley Act has implicated new roles for audit committees and auditors. Auditors will now report to and be overseen by audit committees instead of management. The audit committee must preapprove all services that the auditor will provide, and the auditor is prohibited from offering eight specific non-audit services (bookkeeping, information systems design and implementation, appraisals or valuation services, actuarial services, internal audits, management and human resources services, broker/dealer and investment banking services, legal or expert services unrelated to audit services and other services the board determines by rule to be impermissible) to clients. The auditor must report additional information to the audit committee including accounting disagreements and relevant communications with management. A change from previous practice, audit engagement partners must now rotate every five years instead of every seven.

In addition to these regulations, the Sarbanes-Oxley Act has a few more regulatory policies. Before an audit report is issued, it now must be reviewed thoroughly and approved by a second partner. The act also strengthens the penalties for committing fraud, not maintaining workpapers, and not keeping necessary documents.

The Sarbanes-Oxley Act also requires the comptroller general of the United States to conduct a study and review of the mandatory rotation of registered public accounting firms. A report on this study, which will be presented to the Committee on Banking, Housing, and Public Affairs of the Senate and the Committee on Financial Services of the House of Representatives, is due no later than July 31, 2003 (United States, 2002, p.31). Considering the magnitude of the implications that the enforcement of all the new regulations of the Sarbanes-Oxley Act will bring

to the accounting profession, the fact that legislators are yet considering another monumental regulation in the form of mandatory auditor rotation is amazing.

### **The Mandatory Rotation Debate**

Opponents and proponents of mandatory rotation both have strong arguments regarding the issue. However, despite the length of time this debate has ensued, the basic arguments remain the same (Walker et al., 2001), and little evidence is available to support the adoption (or rejection) of mandatory rotation (Catanach et al., 1999, p.44).

#### **Arguments for Mandatory Rotation**

Most of the arguments for mandatory auditor rotation relate to expectations that the regulation will improve the independence and/or quality of audits (Petty & Cuganesan, 1996, p. 40). The most predominant argument for audit firm rotation is that it will limit the formation of auditor-client relationships that can sometimes lead to compromising independence. Many proponents believe that working in such close proximity with management over several years can impair the judgment of auditors causing them to identify with the interests of management as opposed to those of the public. Rotating auditors every few years will prevent these subconscious biases from developing (Hoyle, 1978, p.71).

Mandatory rotation is also argued to help auditors get a fresh perspective on their clients' financial statements. Proponents of rotation believe that after an auditor has spent several years with a client, his or her approach will get stale. The creativity that the auditor used at the beginning of the audit engagement has been compromised by the increased familiarity with the company's financial statements, systems, and controls. Moreover, not only will the individual auditor's approach become predictable and ineffective, so will the audit programs used to evaluate a company's financial statements and internal controls (Hoyle, 1978, p. 72). A new

audit firm will bring greater alertness and might be able to detect things in statements that the previous auditor might have overlooked (McLaren, 1958, p. 41).

Since the introduction of a new firm will lend a new perspective, it also increases the chances that the errors of a previous firm will be detected and corrected (McLaren, 1958, p.41). Mandatory rotation allows audit firms to scrutinize other firms' actual work instead of just evaluating their controls and compliance with professional standards through the peer review program. Several proponents argue that an audit firm's awareness that another firm will follow it and could very well detect its errors and fraud will motivate that firm to do its best work to avoid embarrassment. The successor firm is also motivated to do its best work because it does not want negative publicity due to its inability to detect the previous firm's errors (Hoyle, 1978, p. 73). As firms, all motivated to do their best work, rotate, clients get several expert reviews on their financial representations (Catanach et al., 1999, p.44), leading to a greater trust from the public.

In addition, mandatory rotation will increase competition between audit firms. The frequency in which corporations would change auditors within the rotation system would require audit firms to constantly improve themselves in order to attract new clients. Rotation would require firms to better their services in order to differentiate themselves from the competition (Hoyle, 1978, p. 72). The proponents also believe that rotation will encourage audit engagements to be better distributed over a greater number of practitioners (McLaren, 1958, p.41).

Auditor rotation also prevents corporate management from using termination of the engagement as a threat when an auditor disagrees with its representations. If an auditor knows that in the next five years his firm is going to have to rotate off of the engagement, the auditor is not under as much pressure to compromise his integrity and comply with the demands of

management. A firm cannot become too economically dependent on one client when every five years it must terminate the relationship (Hoyle, 1978, p. 72).

### **Critique of the Proponents' Arguments**

Most of the arguments for rotation are strong. They are obviously motivated by the public's desire for high quality and independent audits. However, some of the benefits believed to be obtainable through mandatory rotation such as auditor independence could be obtained through other less drastic means. For example, the Sarbanes-Oxley Act's requirement that auditors report to the audit committee instead of management, and its limitation of the nonaudit services (i.e. consulting) that firms can provide will definitely enhance auditor independence.

One might question the argument that rotation gives auditors the opportunity to check each other's work. Given the length of time (approximately two years) required for an auditor to gather and really understand a new client company's history, how does one think that within in a five-year period a new firm will be able to detect previous firm's errors, especially if those errors are intentionally hidden?

Another issue with the arguments for rotation is the need for proof of the assumed benefits. The argument that rotation will increase competition is purely speculative. Even if competition did increase from the implementation of rotation, the competition may not be the healthy type that proponents suggest (Hoyle, 1978, p.72).

The argument that rotation will better distribute audit engagements is not only speculative but also anticapitalist. The United States is based on free market competition. To use the argument of even distribution as a support for rotation goes against the very foundations of the US economy. Those firms who provide the best services should be the ones that get the engagements.

Of all the arguments for the mandatory rotation of auditors, the fresh perspective one is the strongest. It is the only argument that justifies using mandatory rotation specifically as a regulation. The other arguments support rotation, but other forms of regulation could also address the issues they raise.

### **Arguments Against Mandatory Rotation**

Some of the major opponents of auditor rotation come from the accounting profession. Ever since the McKesson Robbins case, the majority of accountants have opposed mandatory rotation. These professionals foresee costs beyond financial ones that do not outweigh the intended benefits of the policy.

One of the most mentioned problems with auditor rotation is the added audit cost to the audit firm, the client, and consequently the public. At the beginning of an audit engagement, various startup costs are incurred as the audit firm gathers information about the company and its systems and processes. The absorption of these initial costs could be considered an investment to the audit firm if it believed that the relationship with the client could develop into a long term one. However, if the company that an auditor has spent all the time and money into studying must obtain a new auditor every five years, then the audit firm has no reason not to pass the incurred start up costs on to its client (Petty et al., 1996, p.41). Furthermore, client companies will not bear these added costs alone, but will pass them on in the form of higher prices to the public (Hoyle, 1978, p.74).

Another argument against mandatory rotation is that the field of auditors to choose from is limited (Anonymous, 2002). Because of mergers and bad business practices, the number of accounting firms capable of auditing multinational corporations has decreased within a relatively short period of time. Just in 1989 the Big Eight accounting firms, which dominated accounting

for most of the seventies and eighties, reduced to the Big Six with the mergers of Arthur Young with Ernst and Whinney and Deloitte Haskins and Sells with Touche Ross. Then in 1997 the Big Six became the Big Five as Price Waterhouse merged with Coopers and Lybrand. With the collapse of Arthur Andersen in 2002, the Big Five has now been reduced to the Big Four. The Big Four accounting firms are Pricewaterhouse Coopers, Deloitte & Touche Tohmatsu, Ernst & Young, and KPMG.

Although the United States has several second tier accounting firms, none of them have the overseas presence necessary to engage in the audits of international firms. Moreover, as the Sarbanes-Oxley begins to be enforced, experts predict the diminishment of second-tier firms due to their inability to absorb all of the new compliance costs (Katz, 2002). What this lack of capable firms means is that if mandatory rotation became law, many corporations would not have a choice of many audit firms to rotate.

The lack of options for larger corporations is further compounded when one introduces industry specialization as a desirable trait in an audit firm. Each firm has a limited number of partners who specialize in particular industries (Petty et al., 1996, p.41). If a company has grown accustomed to receiving advice specific for its industry, the company is not going to want to switch to an auditor who provides more general advice. Furthermore, what may be more detrimental is that auditors will stop specializing in specific industries as they realize they must routinely abandon these industries that required them to gain specialized knowledge (Catanach et al., 1999, p.45).

Another argument against mandatory rotation is that the period of time for the engagement is not long enough. Since most modern businesses are large and complex, a short audit engagement does not give an audit firm enough time to get a thorough understanding of the

company (Hoyle, 1978, p.74). According to the AICPA, problem audits occur more frequently while a firm is becoming acquainted with the business, systems and operations of a company (2002). Audits risks are reduced as the auditor becomes more familiar with a company (Commission, 1978, p.109). Since every five years a firm would again have to go through another learning cycle, the likelihood of problem audits would increase (AICPA, 1992).

In the McKesson Robbins court case witnesses said that learning the history and operations of a company requires a lot of work; however, once the information is retrieved, it can continually be used ("Question", 1967, p.32). However, if audit firms must rotate, then all the research must be completed again, since the successor firm cannot rely on the reports of the previous firm. What is the point of engaging in a couple years of strenuous research only to be able to use the information for a short five-year period? Phillip Politziner, partner of a New Jersey based accounting firm, said that clients receive value from the knowledge that audit firms have acquired over many years and that rotation suggests that an audit is a commodity obtainable from anyone (Anonymous, 2002).

Because of the shortness of an engagement, opponents of rotation also believe that the quality of audits will be diminished because open relationships will be eliminated. According to Clarence Hein, partner of a Denver based accounting firm, many audits are conducted in an environment that promotes open discussion. The company and auditor communicate concerns regarding the accuracy of financial reports, and the company openly discloses the issues it faces. This open dialogue helps auditors produce more quality audits (Anonymous, 2002). Opponents believe that open communication results from the familiarity and comfortableness a client has with an audit firm, and this familiarity and comfortableness develops over time. Consequently, open communication will not be allowed to form with the imposition of five-year engagements.

Mandatory rotation will also reduce quality audits in other ways. First, the increased competition, which some believe will occur due to rotation, will cause price or the promise of an unqualified opinion, rather than quality, to be the focus when selecting audit engagements (Hoyle, 1978, p.74). These pressures that increased competition could produce could lead to more faulty audit work (Catanach et al., 1999, p.45).

While some opponents of rotation believe that competition will increase between audit firms and that the subsequent escalation will lead to more faulty audits, other opponents believe that competition will decrease and the reduction of competition will cause more faulty audits. Mandatory rotation lessens the incentive to compete (and also to invest) because firms know that even if they are successful in obtaining a client, they will have to relinquish that client within a relatively short period of time. As firms lose interest in the growth of the auditing industry, they do not invest as much leading to a decline in efficiency in the industry (Arruñada & Paz Ares, 1997, p.57). Maintaining an active interest in a company's affairs is not easy when an audit firm knows that it will soon lose the client ("Question", 1967, p.32).

Another argument against mandatory rotation is that measures are already in place that address the issues rotation would supposedly correct. For example, the issue of independence of auditors is already strengthened through the policy that requires auditors to report all disputes with management when an audit engagement is terminated (Hoyle, 1978, p.74). The triennial peer review program required allows auditors to check each other's work. The periodic partner rotation policy gives auditors a fresh perspective. Additional rotation of firms would be partly redundant in this case.

Moreover, the natural turnover of management also serves the purpose of rotation by ending lengthy auditor-client relationships. A study of the largest one hundred industrial

concerns by Fortune magazine in 1991 found that forty-seven percent of chief executive officers hold their positions for less than five years. In a review of the largest bank holding companies in 1990, researchers found that eighty-four percent of chief financial officers hold their position for less than five years. These statistics suggest that the management-client relationship is already limited without rotation (AICPA, 1992).

### **Critique of Opponents' Arguments**

The arguments against mandatory rotation are much more numerous than the arguments for rotation. The opposition also has very strong arguments, but that should be expected because criticizing a proposed policy is often easier than developing a new one that addresses all the issues of concern.

The cost and the increased audit risk arguments are probably the most significant and convincing arguments against rotation. However, a study conducted on auditing report failures raises an interesting question that challenges these arguments. Researchers found that the characteristics of companies that voluntarily change auditors are unique and do not represent all companies. This fact is significant because the AICPA, which issued a statement against mandatory auditor rotation in 1992, based its opinions on companies that voluntarily change auditors. The study revealed that companies that voluntarily change auditors are more financially distressed, have less economic power to influence auditors, switch to auditors with less industry influence, and are more likely to have fraudulent activity. Based on these findings the researchers question whether the higher risk associated with new audit engagements is due to the riskiness of the new company instead of the unfamiliarity with the new company. Further extending their case, the authors also question the validity of cost arguments, since they are based upon these

same voluntarily changing companies (Walker et al., 2001). Maybe the switching costs are not as bad as projected.

The argument that says measures are already in place to promote independent and quality audits is not convincing. Though only in a perfect world will audit failures never occur, the magnitude of faulty audits suggests that the current regulations are not enough. The triennial peer review process is beneficial in theory, but no firm has ever failed a peer review despite the numerous failed audits. Deloitte and Touche gave Arthur Andersen a satisfactory review shortly before the collapse of Enron (Ackman, 2003). Some say that no firm is going to slap the hand of another when they all are involved in questionable practices (Svaldi, 2002, p.A.14).

The policy of periodic partner rotation is somewhat helpful, but how is rotating one partner off an engagement really going to offer a new perspective when the new partner is under the influence of the same company, which still holds the same policies, procedures, and pressures? This same question can be applied to the argument that management turnover helps with new perspective. The statistics indicate that even though a percentage of management turns over every so often, a significant percentage of management still remains. If these members of management are active in the company, they can influence any new members to act the same as they do.

Something quite interesting to note is that the primary opponents of mandatory rotation are accountants. In fact in the eyesight of Joe Hoyle, most accountants are firmly against mandatory rotation (1978, p.70). If this statement is true, it should definitely raise doubts about implementing the policy. Should not the opinion of those working in the field matter? These accountants cannot all be trying to protect themselves. Do they have a perspective that the nonaudit world does not? Since auditors are so opposed to rotation, implementing the policy may

not benefit the public because the auditors might decide to find ways to undermine or simply work against the system.

Despite a few criticisms, the arguments against rotation, particularly the one about the limited number of capable firms to rotate, are quite convincing. However, even if rotation is implemented, these arguments show that several issues must be addressed in order for mandatory rotation to be a successful policy. Perhaps looking at the success (or failure) of rotation in other countries will help determine how rotation will fare in the United States.

### **A Look at Other Countries**

Since 1980, Italy has required mandatory rotation. The external auditors on listed companies, insurers, investment houses, newspaper publishers, state owned businesses and companies benefiting from state aid can only serve in their position for a maximum of three three-year terms or a total of nine years (Catanach et al., 1999, p.47).

Maurizio Dallocchio, a professor at Broconni University in Milan, recently conducted a study of Italy's mandatory rotation system. He found that mandatory rotation does not increase competition because audit clients often pre-negotiate the rotation of audit firms, although that rotation should be random ("New Research," 2002, p.6). However, in early 2000, Italy's competition authority fined each of the Big Five accounting firms after discovering that the firms were operating a cartel and fixing audit prices. For an excuse the firms stated that any price agreements made were an effort to keep excessive fee competition from deteriorating the quality of audits ("Breaking", 2002, p.6).

The fact that the Big Five were fined for fixing prices sheds a negative light on them because of their bad ethics. However, this event also sheds a negative light on the policy of mandatory rotation because of its pressure on firms to emphasize cost over quality, proving one

of the rotation opponents' arguments. Furthermore, in Italy the firms have already gained experience evading the system. One wonders if this policy was applied in America whether the firms would apply their same collusive tactics on a grander scale. This incident was not the first time in Italy that firms had been charged with price fixing (Arruñada et al., 1997, p.43)

A recent study of the audit market from Consob, which is Italy's equivalent of the SEC, revealed that for audit firm appointments agreed on for 2000 to 2002, both renewals and new tenures had significantly reduced overall fees and a decline in the average cost per hour of audit work ("Breaking", 2002, p.6). This study suggests that in order to be selected or kept as auditors, Italian firms are lowering their fees. This development is good for the public as long as the firms are not lowering their quality also. However, clients and auditors both perceive a reduction in quality along with the reduction in cost (Bruce, 2002, p.20).

Dalocchio's study also suggests a reduction in cost but only with simple audit fees. In contradiction to the Consob study, he found that overall costs increased, due to more startup costs, for the both the auditor and the client (Bruce, 2002, p.20). This discrepancy in the studies is probably due to the periods studied and the fact that Consob studied new and renewed engagements while Dallochio probably studied all engagements.

Dallochio's study also revealed that Italian regulators have suspended forty partners in Italy since 1980 because of inefficiencies and mistakes and that seventy-five percent of these suspensions occurred within the first year of a new audit appointment ("New Research", 2002, p.6). Though reporters make this number out to be significant, it amounts to approximately two suspensions per year. What the study shows is that the first year of appointment bears a risk of lower quality for the sake of independence. Auditors seemingly become adjusted by the third year of appointment (Bruce, 2002, p.20).

According to Arruñada and Paz Ares, mandatory rotation has hurt Italy and will hurt similar smaller markets due to the fact that specialization is limited by the extent of the market. If an industry is small, then the investment one makes into specialization will not provide a return. As a result audit firms try to merge in order to be more profitable, but Italy has a rule that says mergers can only occur between audit firms that do not have a major presence in the same industry. This rule's purpose is to keep more firms available to rotate within the industry. However, if firms cannot afford to specialize alone and cannot merge with others in order to continue specialization, then firms will stop specializing (Arruñada et al., 1997, p.48). As mentioned earlier, specialization benefits audit quality.

Auditors in Italy complain about the inflexibility of the system. Sometimes, for example during a company merger, companies should keep the same audit firm in order to make the transition easier ("Breaking", 2001, p.6). Based on mandatory rotation in Italy, the only advantage of this policy is the perception to the public that auditors are independent ("New Research", 2002, p.6).

Other countries have tried auditor rotation but not as aggressively as Italy. Spain implemented the system, requiring companies to change auditors every third, sixth, or ninth year. Officials supposedly introduced rotation to allow local firms to gain market share, but their shares did not increase. However, rotation did not increase pressure to lower prices either as feared ("Mid-tier", 1996, p.9). Unfortunate for the argument on rotation, Spanish officials abolished the rule in 1995, eight years into the system, just before the effects of rotation could really be observed, and replaced it with a law that allows companies to renew their audit contracts annually. The whole business profession in Spain welcomed the abolishment of the policy ("Mid-tier", 1996, p.9).

In a report on the efficiency of Spain's auditor rotation system issued just before the rotation law was repealed, Benito Arruñada and Cándido Paz-Ares discovered that rotation results in more expensive and lower quality audits ("Spain", 1995, p.7). Perhaps the report provided further confirmation to the government.

In Germany, two years after the near collapse of the Metallgesellschaft group due to deceitful oil contracts, Bundesbank, the central bank in Germany, under much opposition tried a five-year auditor rotation in an effort to get other German companies to consider the idea ("Germany's", 1996, p.4). Israel adopted three-year mandatory rotation for government companies in the 1970s in order to give more work to smaller audit firms. However, this rule is not strictly enforced because one of the largest and most profitable companies in Israel was granted an indefinite postponement for changing auditors (Catanach et al., 1999, p.47).

Looking at other countries' experiences with mandatory rotation is helpful when evaluating whether it should be implemented in the United States. However, one must remember to take into account national and cultural differences (Catanach et al., 1999, p.48).

### **A Look at DuPont**

E.I. du Pont de Nemours & Company, better known as DuPont, is a unique United States company. From 1910 to 1954, the company successfully and systematically rotated its audit firms with a few exceptions in some years. Below is the rotation schedule of DuPont.

| <b>YEAR</b> | <b>AUDIT FIRM</b>             |
|-------------|-------------------------------|
| 1910        | Price, Waterhouse & Company   |
| 1911        | The Audit Company of New York |
| 1912        | Haskins & Sells               |

|            |                                     |
|------------|-------------------------------------|
| 1913       | The Audit Company of New York       |
| 1914       | Haskins & Sells                     |
| 1915       | The Audit Company of New York       |
| 1916       | Haskins & Sells                     |
| 1917       | The Audit Company of New York       |
| 1918-1919  | Haskins & Sells                     |
| 1920       | Ernst & Ernst                       |
| 1921       | Price, Waterhouse & Co.             |
| 1922       | Haskins & Sells                     |
| 1923       | Price, Waterhouse, & Co.            |
| 1924       | Haskins & Sells                     |
| 1925       | Price, Waterhouse & Co.             |
| 1926       | Haskins & Sells                     |
| 1927       | Price, Waterhouse & Co.             |
| 1928-1929  | Peat, Marwick, Mitchell & Co.       |
| 1930-1938  | Price, Waterhouse & Co.             |
| 1939-1942  | Haskins & Sells                     |
| 1943-1945  | Arthur Andersen & Co.               |
| 1946-1953  | Lybrand, Ross Bros. &<br>Montgomery |
| Since 1954 | Price, Waterhouse & Co.             |

(Zeff, 2003, p.3)

All of the above listed firms have since merged into the Big Four accounting firms. Price, Waterhouse & Co. and Lybrand Ross Bros. & Montgomery are part of PricewaterhouseCoopers. Haskins & Sells is now a part of Deloitte & Touche. Ernst & Ernst have become part of Ernst & Young, while Peat, Marwick, Mitchell, & Co., is now with KPMG. The Audit Company of New York was bought by R.G. Rankin & Co., which later merged with Price, Waterhouse & Co (Zeff, 2003, p.3).

Stephen Zeff, a faculty member of the management graduate program at Rice University, wrote a detailed review of the company during this period. His work serves as the primary source for this evaluation of DuPont.

According to Frank G. Tallman, executive committee member, director, and a member of the upper management of DuPont, the purpose of the company's annual audits was for independent and capable accountants to certify that the company's books were kept in good order and that the financials adequately represented the state of the company. He also said that annual audits serve to inform those with a stake in the company. He believed that independence is more fully obtained when auditors are rotated annually (Zeff, 2003, p.4).

Despite the strong commitment by the du Pont family and some members of upper management to using rotation to ensure independent audits, some people disagreed with the DuPont policy. In a letter written in 1922, the Comptroller advised the company treasurer that annual rotation had no value and is expensive. He felt that it was disadvantageous to a new incoming audit firm because that firm would have to cover the exact same ground as the previous firm, without knowing how to obtain the information that the previous firm already has through familiarity (Zeff, 2003, p.5). Even in 1922 the basic arguments for and against rotation are the same as today.

Walter Carpenter, Jr., treasurer and president of DuPont, also was not in favor of annual audit firm rotation. However, through his tenure as treasurer, he slowly changed his mind to be in favor of rotation. In a letter written just before the McKesson Robbins scandal, he eloquently stated:

It is quite natural that, as the years pass, the work of the various accounting firms becomes more or less formalized. They accept certain practices as being correct or incorrect, whereas in fact that is probably not true. It seems to me, for that reason that occasionally we should have a rotation in order that the practices which we have been following, perhaps for years, are re-examined periodically from the viewpoint of a somewhat different philosophy...

We have been going on for many years with the same auditors. I see that the same faces down here year after year until I, in fact get them confused with our own organization. I do not question their honesty, but I do question somewhat their capacity for constantly, aggressively, opening and reopening questions about theories and practices which we are following. (Quoted in Zeff, 2003, p.8)

While Carpenter now advocated mandatory rotation, he still expressly did not advocate annual rotation. These remarks made by him were powerful and based on first hand experience as treasurer.

At the time he wrote this letter, Price, Waterhouse & Co. had been DuPont's auditor for several years. The company was conducting an experiment to see the benefits of having a long-term auditor (Zeff, 2003, p.6). After the McKesson Robbins scandal erupted (Price, Waterhouse & Co. was the auditor of the company) which was the same year that Price, Waterhouse & Co.

had completed its ninth consecutive year, DuPont went back to rotation, but not annual rotation. The dismissal of Price, Waterhouse & Co. the same year of the scandal was coincidental (Zeff, 2003, p.7).

Despite any negative publicity surrounding Price, Waterhouse & Co., DuPont decided to rehire the firm in 1954 and later on decided to keep the firm permanently. This decision was mainly based on the fact that DuPont's worldwide operations were increasing in scale and complexity and very few audit firms could handle the work. However, the persistence of Price, Waterhouse & Co. in trying to keep DuPont happy also played a part (Allen & McDermott, 1993, p.146). Zeff points out that a review of Price Waterhouse's audit reports for the thirty years following their appointment reveals that the firm never issued an unsatisfactory (or qualified) opinion of DuPont's financial representations (2003, p.12).

In contradiction to opponents that say mandatory rotation will lead to opinion shopping, DuPont kept Arthur Andersen as an auditor despite the firm's rendering of qualified opinions all three years of its tenure. Peat, Marwick, Mitchell & Co. also stayed on as auditor for two years although the firm disagreed with DuPont's policy of recording its surplus account (Zeff, 2003, p.9). Lybrand, Ross Bros. & Montgomery served for an amazing eight years (probably because the du Ponts, who really advocated rotation, starting in 1948 were no longer in the key Chairman or President positions), and also during its time as auditor disagreed with DuPont and issued a qualified opinion in 1947 when the company expensed postwar inflation costs (Zeff, 2003, p.11, 12).

DuPont is an example that mandatory rotation can work, but it also shows that mandatory rotation may not work. For the time that they used rotation, any problems the policy presented were outweighed by its benefits. Otherwise, they would not have continued to use rotation for as

long as they did. Rotation provided DuPont with a fresh perspective and independent and reliable audits. When DuPont conducted its experiment to see the benefits of long-term audit engagements, Carpenter experienced firsthand the confusion of auditor roles about which rotation opponents complain and continued to urge rotation until his retirement (Cheape, 1990, p.90). Even after experiencing the benefits of longer audit engagements, the company decided to return to its rotation policy.

Despite the success of DuPont's rotation system, some points should be considered. When DuPont, a multi-million dollar company, required rotation, it had at least seven firms from which to choose, and it was the only company that had this rotation policy. However, when one compounds the number of companies looking for audit firms and decreases the number of firms capable of handling the businesses, the view that rotation will work as smoothly as it did for DuPont diminishes. Currently, in a country full of multi-billion dollar international businesses, only four capable accounting firms are present. In today's "big is better" society companies increase in size through mergers and acquisitions, making their frameworks quite intricate. Because of the characteristics of today's businesses and the limited number of capable firms, one wonders whether rotation is even executable. Even DuPont, which had an ideal mandatory rotation system, decided to stop the policy because of the lack of firms able to handle its increased in size and operations.

## **Conclusions**

Despite the evidence of providing some benefits, mandatory auditor rotation should not be implemented in the United States. First, every time the government, who supposedly serves public interest, conducts a study regarding whether to implement the policy, the conclusion has

always been against rotation. Moreover, other organizations such as the AICPA have also conducted studies and have drawn the same conclusions.

Secondly, independence, which is the main argument that proponents of rotation use, can be obtained through the Sarbanes-Oxley Act requiring auditors to be hired and compensated by audit committees. Since audit committees are composed of nonexecutive board members, they will advocate the concerns of the shareholders as opposed to those of management. This policy will eliminate the controversial management-auditor relationships that compromise independence.

Thirdly, the majority of the international accounting population is against the idea of mandatory rotation. If most auditors who have to abide by the rule are against the policy then they will find ways to undermine the rule or engage in behaviors to make the government repeal the rule. The behavior of the Big Five in Italy should raise concerns about their future behaviors should rotation be implemented in the United States. These firms already have experience with undermining rotation. Moreover, since there are only four of these firms left, price setting will be even easier.

Speaking of the limited number of firms, the most important reason why rotation should not be implemented is that not enough large firms exist to rotate. Even DuPont, which has probably the most successful experience with mandatory rotation decided to stop the policy because of the lack of capable firms.

At the beginning of an audit engagement a firm has to do significantly more work due to the need to research the company. Many firms have had the same clients for an extended number of years, so they do not have to engage in the extensive background research required in a new audit. Implementing rotation would mean that a firm would always be acquiring new clients at a

rate much faster than it did without rotation. This means that more of a firm's time would be devoted to conducting intense research on the background of its new client companies. Most mid-tier audit firms are not equipped to handle international business, so that means that most of the international companies would have to be rotated among the Big Four. With all the increased research they will have to perform, they might not be able to handle the same number of relatively new clients that they held in old and new clients. Similar problems could occur with mid-tier firms as they acquire more new clients.

If the United States implements mandatory rotation in the near future, it should do some things first. First of all, it should at least wait to see the effects of the Sarbanes-Oxley Act. This law has several new policies that will tremendously affect the accounting profession. Perhaps the appropriate enforcement of these policies will lead to independent and quality audits and mandatory rotation will not even be necessary.

However, if these policies are not enough and rotation is implemented, it should be tested on a sample (perhaps of companies from different industries) first to evaluate any potential benefits or problems. With the number of companies in the United States, implementing such a disruptive policy and then it not benefit the companies would be an atrocity. The United States should also remember to consider the effects of rotation on small businesses, private companies, local governments, nonprofit agencies, and particularly smaller public companies (Anonymous, 2002). Some of these organizations, though not publicly held, could indirectly be affected.

The next suggestion for rotation, which may be common sense, is to stagger the rotations. Every company in the same industry should not switch audit firms at the same time. The risk of a failed audits increases within the first years of an engagement, and this risk may hurt an industry if for some reason multiple audit failures occurred in several of its companies. Staggering

rotations also helps audit firms because if they specialize in that industry they will not be overloaded with or stripped of several engagements in one year.

Rotation may be more successful if the number of years between switches is lengthened to nine years like the Italians or even a little longer. The typical length of many audit engagement far exceed this length. An engagement period of approximately ten years still can serve some of the purposes of rotation. Lengthening the time between switches might make firms less resentful because they will feel their investment in time researching has been compensated.

A final idea is that firms could begin researching their new clients a year before the engagement actually starts. This would give the firm time to gather information about the company without having the stress of completing the first audit with limited information.

Auditor rotation should not be implemented, but if it is, these arguments show that several issues must be addressed in order for mandatory rotation to be a successful policy. However, rather than address all these issues with mandatory rotation, perhaps some alternatives exist that the government could implement that may be more effective.

### **Alternatives to Rotation**

Most would agree that the accounting industry needs more regulation. However, if the provisions of the recently passed Sarbanes-Oxley Act are adequately and legitimately enforced, more independent audits will definitely ensue. Many of the requirements of the new law were once advocated by opponents of mandatory rotation as alternatives. These include the use of audit committees, the elimination of nonaudit services provided with the audit, the change of who the auditor reports to, and stronger sanctions and penalties. Nevertheless, if even more regulation in addition to what the new law provides is required, some other policies should be considered.

One alternative to mandatory rotation is to compensate auditors from a pool of funds that the government controls. The funds could be generated by a tax assessment on all audited companies or on their securities transactions (Commission, 1978, p.105). The hope behind this alternative is that since the companies will no longer compensate their auditors, they will no longer be able to pressure the auditors to render a satisfactory opinion.

One of the main objections to this argument was that if management still had the power to change auditors, then it did not matter who was in charge of compensation. However, now that the Sarbanes-Oxley Act has given the power to change auditors to audit committees, this argument is no longer justified.

Another objection to compensating from a pool of funds is that the fees that companies have to pay give them an incentive to improve the quality of their internal accounting controls so that they can save on audit costs. Internal controls are important because they produce accurate and reliable financial information (Commission, 1978, p.105-106). This very well could be an incentive to companies' improving their accounting systems, but disappointing investors and the audit committee with unsatisfactory audit opinions is also an incentive for companies to continually improve their accounting systems.

Another alternative to mandatory rotation is transferring the task of auditing to the public sector. Since an auditor's purpose is to serve the public interest, then perhaps the public should employ the auditor. A government agency similar to the Internal Revenue Service could be established to audit publicly held companies. This alternative would serve to promote independence because the government agency would have no vested interest in the company.

An objection to this policy is that the government is not completely objective because it does have a vested interest in the financial information of companies. The government uses this

information to accomplish its political and economic objectives through litigation and regulation. For example, consider the government interest in investment tax credits and the frequent congressional actions surrounding it. Because the actual independence of the government is questionable, opponents to this alternative believe that the same type problems would occur as those in the private sector (Commission, 1978, p.105). This is a valid point, but if the policy was implemented, the government would at least try to remain independent because it does not want its reputation to be even more compromised due to failed audits. The failure of private companies is a problem in the public eye, but the failure of a government agency is a much larger problem.

A final alternative to mandatory rotation is joint auditing. With this policy two audit firms would be assigned to each audit engagement. The rationale behind this arrangement is that if one firm succumbs to unethical behavior, hopefully the other one will not and will render an appropriate opinion. Collusion with not just one but both of the firms would have to occur in order for the company to commit fraud, and that at least seems to be less likely. Joint auditing also gives two perspectives to a company's financial information.

The idea of joint auditing is offensive to many auditors because the policy in essence says that one auditor is not enough. France uses this system but joint auditing has not accomplished its intended objectives, according to a general manager at Ernst & Young ("Mid-tier", 1996, p.9). What usually happens with its joint auditing is that one firm (usually a Big Four) dominates the audit because of its size and then uses a smaller firm's signature to get the "joint" classification ("French", 2003, p.5). However, French law has recently begun to require firms to be responsible for an equal share of the work.

Objections to this policy include higher fees and the likelihood of disputes between the two audit teams, considering that auditors from the same firm many times do not agree.

Opponents also believe that smaller firms will not be able to handle their share of the work if they are partnered with a Big Four firm on an audit of a global company (Williams, 2003, p.12).

Although the alternatives to mandatory rotation are also controversial, they are not as popular as mandatory rotation. However, if the government seriously began to consider any of these alternatives, then debates similar to those on mandatory rotation would commence.

### **Summary**

In trying to solve the big problem of getting auditors to consistently produce quality and independent audits, many people are looking for one big magical solution. If rotation is not the answer, then maybe another grand solution is present that everyone is overlooking. However, the reason why the issue of regulating auditors has persisted so long is because people do not realize that the answer may lie in a combination of several smaller regulations. The Sarbanes-Oxley Act, which has a number of new regulations, is a gigantic step that will definitely help if not solve the problem.

However, the public must realize that despite how tight regulations are, audit failures are inevitably going to occur. Blindly implementing a drastic policy, such as mandatory rotation, and hoping for the best will do nothing but further deteriorate the integrity of audits. To conclude, Joe Hoyle states:

The idea of mandatory rotation is something like trying to swat a fly with a baseball bat.

Although it is possible the problem may be solved, the accompanying damage may be irreparable. Mandatory rotation is simply too drastic a step to take without the proof that the benefits are worth the added costs to the company and to the public. (1978, p.5)

## References

Ackman, D. (2003). Headless Body in Andersen Office. Available:

[http://www.forbes.com/2003/01/10/cx\\_da\\_0110topnews\\_print.html](http://www.forbes.com/2003/01/10/cx_da_0110topnews_print.html)

Allen, D.R., & McDermott, K. (1993). Accounting for Success: A History of Price Waterhouse in America 1890-1990. Cambridge: Harvard School Press.

American Institute of Certified Public Accountants. (1992). SEC Practice Section. Statement of Position Regarding Mandatory Rotation of Audit Firms of Publicly Held Companies. New York: Author.

\_\_\_\_\_. (2002, February). A Brief History of Self-Regulation. Available:

<http://www.aicpa.org/info/regulation02.htm>

\_\_\_\_\_. (2002, August). How the Sarbanes-Oxley Act of 2002 Impacts the Accounting Profession. Available: <http://www.aicpa.org/info/Sarbanes-Oxley2002.asp>

Anonymous. (2002, March/April). Local and regional firms comment on AA-Enron impact on SEC practices. Bowman's Accounting Report, 16 (3,4), 20-27.

Arruñada, B., & Paz-Ares, C. (1997). Mandatory Rotation of Company Auditors: A Critical Examination. International Review of Law and Economics, 17, 31-61.

Breaking with the past. (2001, October 16). International Accounting Bulletin, 6.

Bruce, R. (2002, September 17). Rotation of auditors has no impact. USA Edition 2, p.20.

Catanach, A.H., & Walker, P.L. (1999). The International Debate Over Mandatory Auditor Rotation: A Conceptual Research Framework. Journal of International Accounting, Auditing, & Taxation, 8(1), 43-66.

Cheape, C.W. (1995). Strictly Business: Walter Carpenter at Dupont and General Motors. Baltimore: John Hopkins University Press.

Commission on Auditors' Responsibilities. (1978). Report, Conclusions, And Recommendations. New York: Author.

French mid-tier poised to benefit from stricter joint audit regulations. (2003, March 7).

International Accounting Bulletin, 5.

Germany's Bundesbank names KPMG as auditor. (1996, May). European Accountant, 4.

Hoyle, J. (1978, May). Mandatory Rotation: The arguments and an alternative. The Journal of Accountancy, 69-78.

Kahn, J. (2002, January 7). One plus one makes what? Fortune, 145,(1), 88-90.

Katz, D.M. (2002, Dec.31). The Big Eight. Available:

<http://www.cfo.com/printarticle/0,5317,8458,00.html>

McLaren, N.L. (1958, July). Rotation of Auditors. The Journal of Accountancy, 106, 41-44.

Mid-tier hit by audit squeeze. (1996, February). European Accountant, 9.

New Research challenges argument for mandatory rotation of audit firms. (2002, October). The Accountant, 6.

Petty, R., & Cuganesan, S. (1996, May). Auditor Rotation: Framing the Debate. Australian Accountant, 40-41.

Question of Changing Auditors (1967, May). Journal of Accountancy, 123, 31-33.

Ramos, M. (2002, Dec.). SAS 99 Gives CPAs New Chance to Reclaim Reputation. Available:

<http://www.cpa2biz.com/News/Viewpoint/SAS+99+Gives+CPAs+New+Chance+to+Reclaim+Reputation.htm>

Siedman, J.S. (1967, May) Letters to the Journal. Journal of Accountancy, 30-31

Spain: Mandatory auditor rotation is fiercely criticized. (1995, July). European Accountant, 7.

Svaldi, A. (2002, January 27). Experts call for oversight of accountants. Denver Post, p.A14.

United States. Congress. (2002, January 23) Sarbanes-Oxley Act of 2002. One Hundred Seventh Congress, Second Session. Washington, D.C. Available:

[http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107\\_cong\\_bills&docid=f:h3763enr.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_bills&docid=f:h3763enr.txt.pdf)

Walker, P.L., Lewis, B.L., & Castarella, J.R. (2001). Mandatory auditor rotation: Arguments and current evidence. Accounting Enquiries, 10(2), 209-242.

Williams, P. (2003, January 1). Two's too many. Financial Director, 12.

Zeff, S.A. (2003). Dupont's Early Policy on the rotation of audit firms. Journal of Accounting and Public Policy, 22, 1-18.