Audit Firm Rotation vs. Audit Partner Rotation

By Bill Barnes, CPA, CMA

Barnes, Givens & Barnes, Ltd.

The Public Company Accounting Oversight Board (PCAOB) recently requested comment on whether audit firm rotation would improve the quality of audits. Currently, public companies are required to rotate engagement partners every five years; there is no requirement in the U.S. to rotate audit firms. While non public companies and non-profit organizations are not required to rotate audit firms or audit engagement partners, they need to think about the quality of their audits.

First, a little background on PCAOB, audit firm and audit partner rotation – and then some information on how non-profits can help ensure a sound audit.

Congress established the PCAOB, a non-profit corporation, to oversee the audits of public companies to help protect investors and the public interest by promoting informative, accurate, and independent audits. Apparently, its concern is that long-term relationships with audit firms may create problems with objectivity or independence (even though the audit engagement partner is rotated every five years). As expected, the large accounting firms, the American Institute of Certified Public Accountants (AICPA) and several large corporations and non-profit organizations came out against an audit firm rotation requirement. A large accounting firm (Ernst & Young) believes that mandatory rotation would come at a great expense to audit quality.

Studies have shown that audit failures come at a much higher rate during the first three years of an audit engagement, indicating a significant learning curve in the first three years of the engagement for the external auditor, especially with large public companies. The AICPA opposes mandatory rotation due to costly and unintended consequences. It believes that mandatory rotation would hinder the ability of the audit committees to oversee external auditors. The AICPA believes that audit committees should be further strengthened and encouraged to take a more proactive role in overseeing the independent auditor, which would include selecting (or retaining) the most qualified firm for the job. In a letter co-signed by 31 large public companies and large non-profit organizations, they believed that mandatory firm rotation, if implemented, would harm corporate governance, reduce audit quality, diminish the role of audit committees, increase the incidence of undetected fraud and increase costs. Even the PCAOB recognized that mandatory firm rotation would represent a significant change in practice and would increase costs and cause disruptions for companies and external auditors. Former SEC Chairman Richard Breedon favors a system of rotation (10-12 years), but with an opportunity for extension if a PCAOB inspection indicates that there is no loss of independence. Former U.S. Comptroller General Charles Bowsher suggested implementing a system of rotation that would be limited to 25 to 40 of the very large companies. His argument: the cost issue related to rotation would be diminished by the very large budgets of these companies.

So, as the debate continues in the large public company world, what should the non public companies and non-profit organizations consider to ensure that they obtain quality audits?

1 - *A quality audit starts within the organization*. An organization should strive to use qualified accounting professionals who prepare periodic financial statements for review by the board of directors (BOD). The organization should have strong internal controls and adequate segregation of duties.

2 - *Budgets*. An organization needs to prepare budgets that are reviewed and approved by the BOD. Results need to be reported and compared to budget and variances need to be explained and understood.

3 - *Audit committee*. Organizations should consider forming audit committees that hire and communicate with the outside auditor.

4 - *External auditor*. The organization should hire an auditor that is well-qualified and has experience in the organization's industry. The firm should be right-sized. A small, local firm is not well qualified to audit a large, public company. Also, a large national firm may not give a small client the proper attention it needs to provide good value to the organization.

5 - *Partner rotation*. As discussed above, public companies are required to rotate partners every five years. The AICPA believes that this procedure provides the necessary "fresh look" to ensure objectivity. Non public companies and non-profit organizations are not required to rotate partners, but may want to consider the benefits of this process for their organizations.