

Instituut van de Bedrijfsrevisoren  
Institut des Réviseurs d'Entreprises

Koninklijk Instituut - Institut royal

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Our reference  
SVB/svds

Your reference

Date

14 -12- 2011

Dear Sir or Madam,

**Re: PCAOB Rulemaking Docket Matter No. 37: Concept Release on Auditor Independence and Audit Firm Rotation**

IBR-IRE is pleased to provide you with its comments on the PCAOB Rulemaking Docket Matter No. 37 "Concept Release on Auditor Independence and Audit Firm Rotation".

IBR-IRE only provides the following responses to the general questions set out in the PCAOB Concept Release which are relevant from a Belgian, European or international perspective.

**Should the PCAOB focus on enhancing auditor independence, objectivity and professional skepticism?**

IBR-IRE fully subscribes to the aim of enhancing auditor independence, objectivity and professional skepticism in order to have audit quality at the highest level achievable.

It is worth mentioning, in this context, that the use of professional skepticism is a progressive process that can be achieved through a permanent education of the auditors and a full knowledge of the audited entity. But skepticism should also be enhanced at the level of the Board and the Audit Committee where a healthy challenge of management's decisions and accounting estimates should take place.

In Belgium, the education program (3 years minimum and more than 25 exams) in order to obtain the title ends with a jury examination during which professional skepticism is tested thoroughly.



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The clarified ISAs provide clear guidelines with respect to the use of professional skepticism by the auditor (see in particular ISA 200). The creation of additional rules that could lead to a “check-the-box” attitude to the detriment of the sound exercise of professional judgment and skepticism in performing audits, should be avoided.

**Would audit firm rotation enhance auditor independence, objectivity and professional skepticism?**

IBR-IRE is of the opinion that mandatory audit firm rotation may not be the most appropriate approach that in practice would result in such enhancements.

The continuous engagement of audit firms has already been addressed at European level in the Statutory Audit Directive, which considers that the partner rotation within the audit firm every seven years in public interest entities (listed companies, credit institutions, insurance companies) is sufficient to reduce the familiarity threat. This rule is compliant with worldwide generally accepted ethical rules, including the IESBA Code of Ethics. The latter requires rotation of all key audit partners serving on the audit engagement for a public interest entity after seven years. The partner rotation appropriately balances the need for a fresh look on the audit with the need to maintain continuity of knowledge of the client and its environment in order to maintain audit quality.

IBR-IRE believes that a decision to require firm rotation would necessitate consideration of a number of factors, including understanding the cost to the client of educating a new audit firm on the client's business each time it is required to hire a new auditor, such as the potential disruption to the client's operations as core activities undertaken by its personnel are interrupted to inform a new auditor. The impact that firm rotation would have on a client's choice of audit and non-audit service providers would also need to be considered, since the client would need to refrain from engaging certain firms to perform non-audit services in order for them to remain eligible as an auditor due to independence requirements.

**What are the advantages and disadvantages of mandatory audit firm rotation ?**

The Belgian audit profession believes that mandatory rotation entails many disadvantages.



Firm rotation instead of partner rotation increases the audit fees as well as the risk of audit failures, without increasing the audit quality. The key problems of mandatory audit firm rotation are amongst others:

- the significant loss of audit quality due to issues arising from the understanding of the business ;
- an increase of switching costs (i.e. the start-up costs incurred by the client for a new audit engagement) and total costs of audit;
- an increase of risks during the first years of each audit engagement.

With respect to independence, it should be noted that according to best international practices (ISQC 1), the audit firms are requested to regularly verify the continuous acceptance of a client, taking independence rules into account.

Audit quality is enhanced by a sufficient (not too short) period of service of the auditor. In Belgium, auditors are appointed for a three-year term. A mandate between three to six years does appear to be a good safeguard for the statutory auditor's independence.

Several studies examined the impact of audit firm rotation on audit quality, independence, accounting conservatism and audit cost. Often quoted disadvantages are the loss of appropriate knowledge of the client and of the industry, and switching costs. Under mandatory audit firm rotation, auditors lose client specific knowledge and expertise. The conclusions of the papers<sup>1</sup> are very clear with regard to audit quality and accounting conservatism:

- audit quality: all papers conclude that mandatory audit firm rotation has an overall negative impact on audit quality. Most notably, a study<sup>2</sup> points to an immediate threat to audit quality resulting from accelerated rotation as partners report a two-to-three year client familiarization period, and a preference to learn a new industry rather than relocate<sup>3</sup>. Another study shows that the statutory auditors' rotation policy does not improve the audit quality of audit partners<sup>4</sup>. Furthermore, a study using German data finds evidence of more earnings management and manipulation when the audit review partner rotates<sup>5</sup>. A study investigating the extent to which mandatory statutory auditor rotation has an impact on audit quality (Italian, German and French data) confirms that systems of mandatory statutory auditor rotation are related to increased earnings management<sup>6</sup>.

<sup>1</sup> Papers presented at the 33rd Annual Congress of European Accounting Association at Insanbul (May 19 – 21, 2010).

<sup>2</sup> Audit Partner Rotation : An Analysis of Benefits and Costs (Brian DAUGHERTY, Denise DICKINS, Julia HIGGS).

<sup>3</sup> Audit Partner Rotation : An Analysis of Benefits and Costs (Brian DAUGHERTY, Denise DICKINS, Julia HIGGS).

<sup>4</sup> Does a long-term audit partner tenure impair audit quality? A comparison between the Ordinary Least Squares and Linear Mixed Model (Yu-Shan CHANG, Min-Jeng SHIUE, Yu-Jr LIN).

<sup>5</sup> The Effect of Audit Engagement and Review Partner Rotation on Audit Quality (Friederike LINDSCHEID, Christiane POTT, Christoph WATRIN).

<sup>6</sup> The impact of auditor rotation on audit quality (Ignace DE BEELDE).

An Italian study testing the effectiveness of the rotation at both partner and firm level concludes that only mandatory partner rotations might have a beneficial effect on reporting quality<sup>7</sup>;

- accounting conservatism: rotation increases conservatism, but the conclusion of an Italian study is that conservatism is associated with both partner and firm rotation and partner rotations are as effective as firm rotations in enhancing conservative reporting<sup>8</sup>;
- independence: auditor independence may be compromised when auditors with short mandates receive high non-audit fees, but there is no significant association between non-audit fees and earnings management when the auditor's mandates are long<sup>9</sup>.

Furthermore, audit failures are more frequent if auditors have only limited experience with the client<sup>10</sup> and the length of the auditor-client relation has a positive effect on observed independence and audit quality<sup>11</sup>.

The conclusions of the above mentioned studies support the path undertaken by different legislators around the world, who introduced the mandatory rotation rule only at partner level (internal rotation).

Moreover, mandatory external rotation of the firm is disproportionate to the overall objective of financial transparency.

### **Alternatives to mandatory audit firm rotation**

#### *Public tender*

The profession is not in favor of requiring public tenders, because it increases unnecessarily the (already very high) pressure on the audit fees and reduces therefore the quality of the audit. Indeed, audit fees should be sufficient to ensure the application by the auditor of the standards on auditing.

There is a need to focus on the quality of the audit and the necessary resources to perform an audit, including a sufficiently high level of audit fees instead of increasing the competition over fees by imposing public tenders in a market that is already subject to a very high competition. Academic studies demonstrate that higher audit fees increase the audit quality.

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<sup>7</sup> Mandatory auditor rotations and audit quality. Evidence from Italy (Angela PETTINICCHIO).

<sup>8</sup> Mandatory Auditor Rotation, Adoption of IFRS and Accounting Conservatism (Gilad LIVNE, Angela PETTINICCHIO).

<sup>9</sup> Auditor Tenure, Nonaudit Fees, And Earnings Management (WATRIN/POTT/LINDSCHEID).

<sup>10</sup> Audit quality attributes: the perceptions of audit partners, preparers and financial statement users (CARCELLO, HERMANSON and MCGRATH).

<sup>11</sup> Perceptions of auditor independence (SCHELLUCH, THORPE).

The level of audit fees should not be the main criteria to select the statutory auditor as it is the case today.

*Training initiatives and other ways to enhance audit quality*

The general level of audit quality is constantly enhanced and the audit profession is committed to further improve audit quality in the future, i.e. through:

- a) investing in training, permanent education,
- b) developing practical audit tools,
- c) contributing to the standard setting process, under public oversight,
- d) contributing to quality assurance reviews and, where necessary, disciplinary investigations under the ultimate responsibility of the competent public oversight body.

Harmonization of auditing standards by endorsing the ISAs, harmonization based on International Standards on Quality Control (ISQCs) and harmonization of the accounting standards at a high level of quality based on the IFRS, including for SMEs, can also play an important role in order to enhance the quality of the financial information that the auditor has to report on.

External quality assurance activities increase the audit quality. It has to be implemented with inspectors having, or having had, sufficient experience as statutory auditor, under the ultimate responsibility of the public oversight.

The level of the audit quality is already fairly high as demonstrated by the lack of significant issues identified with respect to audits performed before, during and after the 2008 financial crisis. Based on the statistics of the insurance companies covering the audit profession, there have been almost no audit failures in Belgium.

While audit quality is of paramount importance, at one point increasing requirements will however have an unfavorable cost/benefit ratio. In this context, it should be avoided to create the false expectation for the stakeholders that increasing requirements in the audit profession will annihilate any financial risks. The auditor provides reasonable assurance but no insurance.

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In case any initiative would be taken by the PCAOB, IBR-IRE strongly encourages the PCAOB to coordinate any initiatives with its counterparts in Europe and in other parts of the world in order to achieve a coherent, practical and sustainable solution.

Yours sincerely

A handwritten signature in blue ink, consisting of a large, stylized 'M' followed by a vertical line and a small flourish.

Michel DE WOLF  
President