From: doralt@mpipriv.de
To: Comments
Subject: Audit firm rotation
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Attachments: Auditor Independence Max Planck EBOR 2012.pdf

Dear Sir or Madam,

it is with great interest that I have been following the ongoing developments in the US on auditor independence in
general, and in particular in the context of audit firm rotation.

In Europe, the same topic has given rise to a heated debate, sparked by the draft proposaly of the European
Commission.

A small working group of which I am a member has published the attached paper on these questions. We argue, among other
measures, for a multi-year-period of engagement for the audit firm combinded with a mandatory rotation after a maximum
of one re-engagement.

We believe the auditor should be certain that disagreements can not lead to the immediate loss of the client, as is
currently the case in practice (hence the necessity of a multi year engagement).

At the same time, there should be certainty that the client will have to engage a different auditor after a certain
number of years. This would allow the current auditor to act in more independence, ignoring open or implicit pressure
by the audited firms management when disagreements arise. It would also reduce the permanent pressure on the auditor of
having to please the client in order to ensure his re-appointment (or to ensure not to lose the client).

Kind regards,

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Auditor Independence at the Crossroads – Regulation and Incentives

Max Planck Institute Working Group on Auditor Independence*

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Abstract
In November 2011, the European Commission published legislative drafts proposing radical reforms for statutory audits in Europe,[1] *fuelling heated political and academic debates.*[2] *This paper presents cornerstones for a new regulatory framework of auditing and thereby contributes to the ongoing debate on the role of auditors and their independence.*

Keywords: auditor independence, auditing and consulting services, bias, public-interest entities, disclosure, internal and external auditor rotation.

1. GENERAL REMARKS

Statutory audits are a pillar of European and global financial markets. They are also a precondition for the functioning of companies, and, irrespective of the regulatory approach which the EU will eventually adopt, the role of statutory audits for corporate governance will stimulate future research. The issues recently addressed by the European Commission are fundamental and have relevance for a wide range of corporate governance topics. Trust in the independence of auditors is essential because transaction costs in markets are bound to rise when independence is lacking or is perceived to be lacking. Auditing quality is directly linked to auditor independence and to auditor liability.[3] The role of the statutory auditor is not to provide comfort about the financial state of the company but to perform a thorough and reliable audit as to the accuracy of the accounts, reducing the possibility of undetected errors based on fraud or negligence on the part of the management. When markets no longer trust the accuracy of audited accounts, the costs of trade increase and in some cases markets collapse as a result. These dramatic consequences can currently, again, be observed in the collapse of the inter-bank lending market where banks no longer trust the accuracy of each other's published (and audited) accounts. The key feature to ensure trust in the value of a statutory audit is the independence of

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1 Proposal for a Regulation on specific requirements regarding statutory audit of public-interest entities, COM (2011) 779/3, 2011/0359 (COD); proposal for a Directive amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, COM (2011) 778. These drafts were published on 30 November 2011 and followed the public consultation held by the European Commission after the publication of its Green Paper on Audit Policy: Lessons from the Crisis, COM (2010) 561 final, 13.10.2010.

2 Amendments to the legislative process are therefore still possible. See, in this context, the European Parliament Resolution on Audit Policy: Lessons from the Crisis, 2011/2037 (INI) of 13.9.2011, which substantially differs from the previous Resolution of the European Parliament of 31.5.2011.

3 See, in this context, the report submitted to the European Commission by the Max Planck Institute Working Group regarding auditor liability (published as 'Auditors' Liability and Its Impact on the European Financial Markets', 67 *Cambridge Law Journal* (2008) pp. 62-68).

the auditor. We believe the current legal framework is insufficient to safeguard auditor independence. Structural changes are needed.

The drafts published by the European Commission so far would amend the Audit Directive (2006)[4] and introduce a new regulation for the audit of public-interest entities (PIEs).[5] The aims pursued by the European Commission are twofold: to change the market structure, leading to less concentration in the auditing industry serving PIEs, and to strengthen auditor independence. While some rules may serve both aims, others may help to increase independence while furthering concentration and vice versa. This conflict does not seem sufficiently reflected in the European Commission's proposals.

In our view, independence of auditors is the single most important issue in the context of auditing today. The suggestions made in this paper therefore aim at strengthening auditor independence only.[6] They are intended as a system of complementary rules, rather than a set of independent rules, suitable for individual implementation.

2. Cornerstones of a New Regulatory Framework for Auditor Independence

1. Auditing firms should remain entirely free to provide consulting services to companies that they do not audit.
2. The statutory auditor should not be banned from all consulting work for the audited company. However, services that have a direct impact on the annual accounts should not be permitted.
3. All payments made to the statutory auditor by the audited company should be published in the audited company's annual accounts, categorised as audit and non-audit fees.
4. Non-audit services provided by the statutory auditor to the audited company should be limited. One possible method of limitation could be to allow such services up to an amount not exceeding the audit fees. A lower threshold should be considered for PIEs.
5. In companies with non-executive directors or a supervisory board, these bodies should be required to approve all arrangements entered into by the company with its statutory auditor, including non-audit services performed by the statutory auditor.

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[4] Directive 2006/43/EC on statutory audits (2006 Audit Directive), *OJ* 2006 L 157 of 9.6.2006.

[5] For a definition, see Art. 2, No. 13 of the Audit Directive (*supra* n. 4).

[6] With one exception: see *infra* 5.6, where possible consequences of mandatory external rotation of audit firms – in our view necessary for reasons of independence – are discussed in the context of their impact on the auditing market.

6. When an audited company generates a substantial part of the audit firm's revenues, this should be published in the annual accounts of the audited company. We suggest a threshold of 5% of the total revenues of the audit firm.
7. a. We recommend that the auditor and audit firm should be excluded from performing the statutory audit for a company after a total engagement of eight years.
   b. The exclusion should apply to the lead audit partner, to the audit firm and to audit firms of the same network.
   c. We recommend that the auditor or the audit firm should be appointed for a fixed period: the initial appointment should be for four years, renewable once for another period of four years. The renewal should be conditional on internal rotation of the lead audit partner taking place after the first four-year term.
   d. Termination of the audit engagement within a period of appointment should only be allowed for a proper reason (just cause) or in exceptional circumstances (e.g., in case of a change of control in the audited company resulting from a merger or an acquisition).
8. A legislative act should ensure that potentially differing rotation schedules of Member States do not force a corporate group to change statutory auditors for its affiliates at different times.
9. The implementation should provide for a step-by-step approach in order to allow a gradual adaptation of the market and to avoid disruptions in a single year; the implementation should start with companies that have had the same auditor for the longest period.

We believe that through the introduction of these measures the independence of auditors and the perception thereof could be substantially improved. The proposals are not limited to the audit of PIEs but modifications may be considered for the audit of other companies.

3. APPOINTMENT OF THE STATUTORY AUDITOR

3.1 The influence of the management on the appointment of the auditor

Auditors are currently appointed by the company they audit. This is likely to cause a conflict of interests even if shareholders and not the (executive) management appoint the statutory auditor, as required by Art. 37(1) of the 2006 Audit Directive. Auditors compete in a market known to be highly competitive, and new audit clients are frequently perceived as a key to new consulting mandates. As a consequence, many auditors admit that statutory audits are frequently offered at low prices in the hope that they will lead to profitable consulting work for the same client ('low-balling'). Incentives for auditors to offer statutory audits at low fees (or even below costs) reinforce the structural problem caused by the appointment and remuneration of the

auditor by the audited company. Art. 25(a) of the 2006 Audit Directive does not seem to have solved this problem.

The conflict is linked to the fact that the management still frequently influences the choice of auditor. This is hardly surprising if one considers the common European shareholder structures: where there are dominant shareholders, the executive management is directly dependent on a relationship of trust and confidence with these shareholders in a one-tier corporate structure and indirectly dependent in a two-tier corporate structure. Important decisions of shareholders are usually discussed with the management (and vice versa). As a result, the appointment of auditors will continue to be influenced by (executive) managers as long as the structure of shareholdings includes substantial or dominant investors, be they families, banks or other professional investors. In such an environment, auditors are likely to be motivated to please the management to secure their reappointment, or to put it differently, they will have strong incentives to avoid conflicts with the executive management so as not to endanger their reappointment (see below under 3.3). The measures we propose would reduce the conflict of interests to a tolerable level because the auditor would know from the start that the appointment would be for a multi-year period and that indefinite reappointment would be excluded – concerns about auditing procedures or accounting practices could then more easily be raised by the auditor without having to fear the loss of his mandate.

3.2 Auditors should be selected and appointed by the companies they audit

We believe the European Commission is right to abandon the idea of delegating the choice and appointment of auditors to a public authority or other body. In our view, this competence should remain in the hands of the audited company. The appointment of the auditor by the company fosters competition in the market for statutory audits, leading to efficiency gains at various levels. Costs are reduced (perhaps, occasionally, too much due to 'low-balling'). Most importantly, however, companies can choose the auditor they consider adequate and best prepared for their audit. Different companies may require different types of expertise (banks, for instance, will require a different type of team for their audit than an energy provider, and a global business may find a 'big four' audit firm more attractive, while a local company may prefer a smaller, local audit firm). These choices demand intimate knowledge of a company and its business. Hence, it seems preferable that the choice be made by the company, as is currently the case.

By contrast, we believe the choice by a public authority or agency would create disadvantages similar to those it is designed to solve while potentially adding substantial new difficulties. The appointment would need to be made in a transparent and independent way. The question of how to remunerate the statutory auditor would need to be dealt with: who should pay (i.e., the audited company directly or a pool of all companies?) and who would define how much should be paid for the statutory

audit? These issues can be dealt with best and most efficiently through market processes.

4. AUDITING AND CONSULTING SERVICES

4.1 Banning auditing firms from providing consulting services to firms they do not audit?

The European Commission currently proposes to ban large existing auditing firms and networks from auditing PIEs if they offer consulting services in the EU. This would result in a break-up of existing auditing firms and networks into at least two entities, one providing auditing services to PIEs, the other offering consulting services. According to the European Commission's draft Regulation[7] (Art. 10(5)), these entities should in principle be fully independent (notably, they should not be linked by a network or have substantial ties at the level of ownership).

The reasoning behind this rule seems doubtful – it may be intended to change the market structure or to strengthen independence. In our view, this approach is misguided. The impact of the proposed ban on the market structure seems entirely uncertain. As for independence, we see no justification for banning auditing firms from providing consulting services to companies they do not audit. The envisaged ban and the resulting break-up of existing auditing firms and networks, as proposed by the European Commission, is neither necessary nor justified. Additionally, the skills and knowledge that auditors have accumulated through consulting services may enhance the quality of audits in general and would risk being lost if the European Commission's proposal were to be enacted. Finally, the auditing profession might face difficulties in recruiting sufficient numbers of highly qualified persons, as the exclusive focus on auditing could be perceived as a less attractive career choice.

4.2 Should auditing firms be forbidden to provide consulting services to companies they audit?

The statutory auditor should not be completely banned from providing consulting services to the audited company.[8] Although such a ban would constitute a clear and easily enforceable rule, it would impose a far-reaching restriction on the professional

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[7] *Supra* n. 1.

[8] The draft Regulation (*supra* n. 1) proposes a ban on all consulting services that are not categorised as audit-related financial services (Art. 10(2)), permitting, for instance, the audit of interim financial statements and the assurance regarding the corporate governance statement, while other consulting services would, in principle, be forbidden. Additionally, even the services not forbidden *per se* would only be allowed on the condition that the fees generated do not exceed 10% of the fees generated by the statutory audit (Art. 9 (2)).

freedom of auditors. The public interest in securing auditor independence can, in our view, be achieved with less restrictive measures (see below). A complete ban on consulting services may be incompatible with the European principle of proportionality (Art. 5 TEU). By comparison, however, Annex I, Section B, no. 4 (sent. 1) of the Regulation on credit rating agencies[9] contains a strict rule forbidding a credit rating agency to provide consultancy or advisory services for the rated entity or a related third party; only 'ancillary services' such as market forecasts (sent. 2) are permitted, as long as they do not create a conflict of interests. Additionally, they have to be disclosed when provided to the rated entity (sent. 3).[10]

In our view, providing consultancy services to the audited company may create a conflict of interests for the auditor. Empirical studies point to a bias in these situations.[11] The bias is frequently unconscious and auditors may indeed deem themselves independent even when they offer substantial consulting services to the audited company.[12] We believe that, as a rule, the statutory auditor should avoid substantial non-audit engagements with audited companies regardless of the exact nature of the services provided (tax, legal or other advisory services).

Legislation in many Member States addresses the most blatant form of conflict by prohibiting consulting services for a range of issues that directly impact the annual accounts. This reduces but does not eliminate the more general conflict rooted in the financial incentives provided by non-audit services, especially where the fees exceed those paid for the audit. The problem of 'low-balling' highlights the (dis)incentives. In our view, this conflict should be addressed.[13]

First, the audited company's annual accounts should mention all fees paid to the statutory auditor, disclosing separately the amount of audit fees and non-audit (consulting) fees.

Second, the total amount of fees generated by consulting services should be limited. In this context, some major audit firms advocate for a complete ban on consulting engagements for audited companies. Others plead in favour of limiting the amount of non-audit fees to a low percentage level of the audit fees. In our view, non-audit fees paid by a company should not exceed the level of its audit fees. For PIEs a lower threshold should be considered.[14]

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[9] Regulation 2009/1060/EC on credit rating agencies, *OJ* 2009 L 302/1 of 17.11.2009.

[10] A similar approach is now envisaged in the draft Regulation; see *supra* n. 8.

[11] Max Bazerman, George Loewenstein and Don Moore, 'Why Good Accountants Do Bad Audits', 80 *Harvard Business Review* (2002) p. 97.

[12] Ibid.; Don Moore, Philip Tetlock, Lloyd Tanly and Max Bazerman, 'Conflicts of Interest and the Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling', 31 *Academy of Management Review* (2006) pp. 10-29; in a wider context: Andreas Glöckner and Christoph Engel, 'Role Induced Bias in Court: An Experimental Analysis', Preprints of the Max Planck Institute for Research on Collective Goods Bonn, 2010/37.

[13] The draft Regulation (*supra* n. 1) addresses these issues; it proposes solutions going far beyond what we consider necessary.

[14] The draft Regulation (*supra* n. 1) limits consulting fees to 10% of the audit fees, in addition to a far-reaching ban applying to most consulting services.

Third, our recommendation as to the appointment of the auditor for a period of several years should be seen as a necessary addition. Taken together, these measures might mitigate the problem of 'low-balling' in the future.

Fourth, where possible, the approval of shareholders (or non-executive directors or the supervisory board, as the case may be) should be required for any non-audit engagement the company enters into with its statutory auditor.[15] Even if the executive management could still hire the audit firm for a non-audit engagement, this measure would enhance transparency. The need for approval would mirror existing rules of Member States on contracts between supervisory board members and the company. Alternatively, the company could be represented by those bodies (i.e., the supervisory board or the non-executive directors, as the case may be) for all arrangements with its auditor.

Fifth, when an audited company generates a substantial part of the audit firm's revenues, this should be published in the annual accounts of the audited company. We propose a threshold of 5% of the audit firm's total revenues.[16]

5. TIME LIMITATIONS ON THE CONTINUOUS ENGAGEMENT OF AUDIT FIRMS AND THE QUESTION OF MANDATORY ROTATION

5.1 Internal and external rotation

In order to increase the independence of statutory auditors, two systems of rotation have been widely discussed. After a certain number of years, an 'internal rotation' requires the lead audit partner to be changed, allowing another partner of the same audit firm to perform the audit in the following years, while an 'external rotation' also requires a change of audit firm. Both types of rotation have been criticised by the audit profession. The main contention is that additional efforts would be required in the first and second year following such a change as a new auditor would need to become familiar with the company. This increases the costs of the audit.

5.2 The cost factor

The amount of additional costs depends on the specific circumstances. In our view, the Commission should inquire specifically about the amount of these additional costs. According to informal information, these costs generally amount to a lower double-digit percentage figure in the first year and about half that figure in the

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[15] This suggestion is now reflected in Art. 11(4)(c) of the draft Regulation (*supra* n. 1), where permission by the audit committee is required.

[16] For the proposed requirements regarding publication in the accounts of the auditing company (rather than the audited company), see Arts. 21-23 of the draft Regulation (*supra* n. 1).

second year. We recommend external rotation of the audit partner and audit firm after eight years at the latest (3.4); the additional costs should be seen in the context of the entire period of engagement: spread out over up to eight years, the total additional costs per year are likely to be moderate. Also, such costs have to be weighed against costs caused by the lack of trust in audited accounts due to impaired auditor independence.

5.3 Incentives to please the management of the audited company and the unconscious bias problem

In our view, the incentive for auditors to retain the audited company as a client lies at the heart of the independence issue. Under the current framework, the audit firm and the audit partner have an incentive to please the client in order to maintain the client relationship. We believe the current system maximises insecurity for the auditor. According to Art. 37(1) of the 2006 Audit Directive, the statutory auditor is appointed by the general meeting of shareholders. In most Member States, national laws only permit a yearly appointment. This subjects the statutory auditor to permanent pressure. Raising objections about the accounts or audit procedures undeniably creates the risk of losing the audited company as a client, as publications by leading auditors admit. In this regard, auditors are currently placed in an ejection seat.

In addition, while auditors may consider themselves independent, the mere fact that they have strong incentives to please the management of the audited company in order to secure re-engagement for the subsequent year introduces a bias into their judgment. Empirical studies suggest that this bias is powerful and frequently unconscious.[17]

5.4 The case for external rotation and appointment for a longer period

We believe there should be a time limitation on the auditors' engagement with an audited company. In our view, a change of auditor and audit firm would need to take place after eight years at the latest.[18] This should be complemented by appointing the auditor or audit firm not just for a period of one year, as is currently the case. In our view, the initial appointment should be for a period of four years. During this period, a change of auditor or auditing firm should in principle be excluded, unless proper grounds or particular circumstances justify dismissal. Similarly, the auditor or auditing firm should in principle be prevented from resigning from the engagement

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[17] See *supra* nn. 11 and 12.

[18] Art. 33(1) of the draft Regulation (*supra* n. 1) requires a minimum initial appointment period of two years, with one possible renewal of the engagement only and a maximum duration of six years (unless the audited company opts for the cumbersome concept of joint audits by at least two auditing firms, in which case the maximum duration of the engagement is nine years).

before the end of the four-year period, unless for just cause. This would prevent the auditor from dropping a client when noticing irregularities.

The mechanisms for dismissal before the end of the appointment are already set out in Art. 38 of the 2006 Audit Directive, requiring 'proper grounds' (which explicitly excludes divergences of opinion on accounting treatments or audit procedures). In this vein, the auditor or auditing firm could be dismissed before the end of a four-year appointment only on proper grounds (just cause) or when particular circumstances justify a change of auditor. Such a circumstance would, for instance, be a change of control or a merger affecting the audited company; following such events, the newly formed company or group of companies should be free to appoint either of the previously engaged statutory auditors.[19] A regulation should contain a list of situations in which, exceptionally, premature termination is possible.

The remuneration should be fixed at the beginning of the audit engagement. Adaptation should be possible for substantial and unexpected changes in the amount of work necessary for the audit (more hours may be required in cases of crisis or strong growth of the company, less if major parts of its businesses are sold or shut down, etc.). A court or professional body could be in charge of resolving disputes arising in this context.

After the initial four-year appointment, renewal should be permitted only for one additional period of four years. This renewal should be conditional on internal rotation. After a total of eight years, a change of auditor should be mandatory. The outgoing auditor, his or her audit firm and audit firms of the same network should be excluded from acting as statutory auditor of the company for a four-year period.

We believe these measures would significantly improve auditor independence for the following reasons: first, the audit firm would no longer need to invest efforts in maintaining the client relationship with the audited company on a permanent basis. From the start, there would be certainty as to the fact that after eight years a renewed engagement would no longer be possible – neither for the partner responsible for the audit at that time, nor for the audit firm. Second, an auditor would no longer face the danger of losing a client because of divergences of opinion on accounting treatments or audit procedures. Third, an individual auditor or audit firm would be aware of the fact that – after eight years at the latest – a competing auditor or audit firm would be reviewing the previously audited accounts. This would probably lead to more caution and certainly to more independent reasoning by the auditor. Fourth, the danger of a self-serving bias arising in long-term audit appointments would be greatly reduced, as a complete re-assessment and new planning of how to structure the audit would take place upon the (mandatory) change of audit firm. Academic and empirical studies suggest that self-serving bias is a real threat to auditor independence.[20]

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[19] These crucial rules, allowing for adequate exceptions to the principle of longer-term appointments, are, unfortunately, missing in Art. 34 of the draft Regulation (*supra* n. 1).

[20] See *supra* nn. 11 and 12.

From the perspective of audit firms, this proposal has the advantage of an irrevocable appointment for at least one four-year term (and the possibility of one renewal). The lead audit partner would not need to invest time and effort in order to secure a yearly reappointment, as is now inevitably necessary (and which is very problematic, given the independence requirements). The same argument applies to the second four-year period when another lead audit partner has taken over.

In the drafting process special attention should be devoted to formulating a wording that excludes the circumvention of mandatory external rotation through the appointment of another audit firm from the same network.

Finally, it should be ensured that a new auditor has full access to all necessary information about the previous audits.[21] The rule contained in Art. 23(3) of the 2006 Audit Directive already obliges an outgoing statutory auditor or audit firm to 'provide the incoming statutory auditor or audit firm with access to all relevant information concerning the audited entity'. Taken seriously, this rule provides new auditors with the necessary information, including that on previous audits.

5.5 Special rules for groups of companies

Introducing external auditor rotation through a minimum harmonisation directive may lead to different rotation periods or rules in Member States. As a result, groups of companies operating in several Member States may face the risk of having to employ different audit networks or audit firms, leading to unnecessary complications.

This can and certainly should be avoided. A regulation, or a directive mandating a single rule by way of maximum harmonisation, should ensure that a corporate group can choose a single audit network and subject all its subsidiaries to the same rotation schedule.[22]

5.6 Effects on the structure of the auditing market and on market concentration

One might question whether competition in the auditing market is properly working at present, given that companies in general do not change their statutory auditor frequently and the big four audit firms dominate the market. When changes nevertheless occur, they often lead to the appointment of yet another big four audit firm, furthering the concentration. Hence, right now, there is only competition among audit firms for those few clients that wish to change their firm at a given moment. Our proposal aims at reinforcing competition in the audit market. If a legal require-

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[21] This is reflected in Art. 33(5) of the draft Regulation (*supra* n. 1).

[22] By opting for a legislative proposal in the form of a regulation, differing rotation schedules in different Member States could be avoided because of the uniform direct applicability.

ment were to introduce external auditor rotation, one possible result could be that the big four audit firms may be unable to seamlessly accommodate the larger number of shifts. While the outcome of such a scenario is uncertain, it could benefit especially the leading second-tier-sized audit firms, already established with a strong international reach. This may increase the number of large audit firms from the current number of four to five or six in the future. Apparently, concentration has been observed in the context of mandatory external auditor rotation in Italy;[23] this may, however, also be due to the global concentration process over the past decades. In our view, markets are likely to react differently if mandatory external auditor rotation is introduced throughout the EU now. We expect competition to be spurred, benefitting in particular the leading second-tier-sized audit firms.

5.7 Implementation

The highly concentrated audit market may experience initial difficulties when implementing the recommendations made above. In our view, external rotation should be implemented step by step in order to avoid too many companies having to change their auditors in the same year. Many solutions are conceivable. One solution could be to start the implementation of mandatory rotation first for the audits of those companies that have had the longest relationship with their auditor or auditing firm. Mandatory rotation could then gradually be introduced for the audits of all companies.[24] This would allow the market to adjust gradually while putting in force the principle of rotation without further delay.[25] A possible start could be to first

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[23] Cf. Mara Camaran, Dino Di Vincenzo and Emilia Merlotti, 'The Audit Firm Rotation Rule: A Review of the Literature' (2005), available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=825404>.

[24] We suggest starting the introduction of mandatory rotation with companies that have had the same auditor or audit firm for 20 years or more. In the subsequent year, rotation could be introduced for companies audited by the same auditor or audit firm for 15 or more years, then for those with an auditing relationship of 10 or more years and finally for those with an auditing relationship of 8 or more years. The draft Regulation (*supra* n. 1) takes a similar approach: it allows a single reappointment of the same auditor or audit firm for one year if the auditor or audit firm has served a company for more than 100 years; a single reappointment for a period of up to two years is allowed if the auditor or audit firm has served a company for more than 51 and up to 100 years; a single reappointment for a period of up to three years is allowed if the auditor or audit firm has served a company for more than 21 and up to 50 years; a single reappointment for a period of up to four years is allowed if the auditor or audit firm has served a company for more than 11 and up to 20 years; a single reappointment for a period of up to five years is allowed if the auditor or audit firm has served a company for less than 10 years (Art. 70(1)(c)(i)-(vi); these rules, for the introductory period, derogate from Arts. 32 and 33).

[25] A similar approach is taken by the draft Regulation (*supra* n. 1) in Art. 70, where renewal of the auditing contract is possible during a transitional period; the maximum number of years for which the previously engaged auditor can be reappointed during the transitional period varies between one and five years, depending on the duration of the previous engagement with the audited firm.

implement mandatory rotation for PIEs. This too may have the benefit of spreading the change over a period of time, and it could be politically wise to start with the largest and often most important companies first.

5.8 Why the current model of internal rotation creates costs but does not substantially improve independence

In our view, mere internal rotation is not a good solution, and the European Commission rightly addresses alternatives in the Green Paper. Art. 42(2) of the 2006 Audit Directive introduced internal rotation for PIEs. It seems surprising that this measure was taken to increase auditor independence. The incentives for a statutory auditor to maintain the audited company as a client remain the same after implementation of internal rotation: the lead audit partner must ensure that the client is not lost. While audit firms may not be dependent on individual clients, the individual partners, and their standing within the audit firm, will depend very much on whether they lose one of the few clients they personally serve. Audit partners' remuneration will in most cases be directly affected when losing a client. All the incentives for securing re-appointment every year are kept in place. Diverging opinions on accounting treatments or audit procedures can only be raised at the risk of losing the client. Most importantly perhaps, the risk of a self-serving bias remains in place as the (often more senior) lead audit partner is frequently replaced by a (more junior) partner of the same audit firm who will be reluctant to second-guess approaches taken in previous years.

As a result, while internal rotation may help to prevent the formation of long-term and intimate relationships between auditors and managers, it does not significantly increase independence. Moreover, internal rotation is by no means a solution that avoids the increased costs complained of in respect of external rotation. As with a partner in a new audit firm, a new partner in the same firm would also initially need to spend extra time on the audit.

In addition to existing conflict of interest rules for employees in various Member States, uniform European standards with regard to duties to inform authorities in specific circumstances (so-called whistle-blowing),[26] prohibitions against accepting gifts, cooling-off periods before taking a position as employee of an audited company, etc.,[27] are, in our view, necessary and should therefore be introduced.

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[26] See Art. 66 of the draft Regulation (*supra* n. 1).

[27] See Arts. 5-8 of the draft Regulation (*supra* n. 1).