



**International Chamber of Commerce**

*The world business organization*

## **ICC Policy Statement**

### **The adverse effects of compulsory audit firm rotation**

Prepared by the Commission on Financial Services and Insurance, 4 March 2005

#### **Introduction**

This policy statement outlines world business views on the issue of compulsory audit firm rotation.

A number of recent, high-profile corporate failures have raised concerns about the accuracy and reliability of company financial statements. Although the prime responsibility for preparing financial statements rests with company management, as overseen by the Board of Directors, criticism also has been levelled at the quality of external audits and the independence of auditors. Some observers and regulators have suggested that auditor independence could be strengthened by a system of compulsory rotation of audit firms after a specified period of time. This system has been adopted or is under consideration by a number of national governments, even though there is little if any evidence to demonstrate its effectiveness.

ICC strongly supports the principle of auditor independence and recognizes that it is essential to maintaining confidence in audit quality and the quality of financial reporting. The integrity of financial reporting, of course, is critical to the effective and efficient functioning of the world's capital markets.

However, ICC believes that compulsory rotation of audit firms is the wrong solution for correcting real or perceived weaknesses in auditor independence and that compulsory rotation would have several adverse consequences, including negative effects on audit quality. Regulators have a number of other policy options that could strengthen auditor independence without these adverse effects.

#### **Business concerns about compulsory rotation**

- Audit effectiveness depends upon the audit firm's accumulated knowledge of, and long-term experience with, the client's operations and complex reporting issues. Compulsory rotation undermines this accumulation of knowledge and experience. Audit problems occur much more frequently when the audit firm lacks this base. In the first few years auditors will know less about the client company and its management, and will be in a weaker position in making judgments about reporting issues.
- Compulsory rotation acts as a disincentive to the auditor to make investments that enhance quality. Knowing that the client relationship will be of fixed, usually rather short, duration, increasing resources and attention will be focused on new client development. No matter how much is invested in improving engagement quality, the rewards are lost with the next rotation.

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- Compulsory rotation of audit firms increases audit costs and creates significant practical problems. With each rotation, a whole new tendering process must be carried out and a new audit team must be brought up to speed on the client's operations and reporting issues,

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involving significant management time. Potentially numerous rotation requirements around the globe, operating on different time cycles, multiply the added costs to transnational enterprises and significantly complicate management of global audits.

- Compulsory rotation does not appear to have the claimed benefits of opening up opportunities for new providers of audit services; in fact, recent studies suggest that it increases concentration among the largest firms. If the audit market for listed companies is concentrated or limited, it may be difficult to identify an audit firm that is willing, able and qualified with respect to independence to accept the engagement.
- Compulsory rotation restricts freedom of choice and the ability of audit committees, boards and shareholders, where appropriately charged with this responsibility, to determine which audit firm best meets their requirements from an open, competitive field.

### **Better alternatives to protect independence**

- The appointment of auditors based on a qualified evaluation of their performance by experienced and competent board members (including audit committee members or members of other appropriate bodies) is a prerequisite of high-quality audits.
- Strong professional rules on auditor independence, especially with regard to financial, business or familial relationships with clients, are critical to safeguarding independence. These need to be backed by monitoring and enforcement systems.
- Restrictions on certain types of non-audit services that can be provided to audit clients also help safeguard independence. Examples of those that may create conflicts are bookkeeping services, management functions, or internal audit outsourcing.
- Effective audit committees of the board, with independent, financially-astute members, can play a critical role in helping to assure auditor independence. Already, many jurisdictions require external auditors to be hired by, and report to, the audit committee of the board, which is composed of, or headed by, independent directors. This increases the auditor's independence from management.
- Periodic rotation of the engagement partner and/or senior members of the engagement team address the threat of over-familiarity with the client, without causing the loss of accumulated knowledge and experience, and the consequent negative effects on audit quality, that firm rotation would entail.
- Market forces frequently help promote auditor independence. Companies are able to re-tender their audits and engage new firms if they so desire; senior members of management move and assume different responsibilities so that the relationships with the auditor are changing all the time; and audit firms themselves have a great deal to lose in the marketplace when their reputations are tarnished by audit failures or ethical lapses.

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**For these reasons, ICC urges governments and regulatory authorities to reject compulsory rotation of audit firms and to support and implement more effective alternatives for reinforcing auditor independence that will not damage audit quality.**



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### **About ICC**

ICC is the world business organization, the only representative body that speaks with authority on behalf of enterprises from all sectors in every part of the world. ICC promotes an open international trade and investment system and the market economy. Business leaders and experts drawn from the ICC membership establish the business stance on broad issues of trade and investment policy as well as on vital technical and sectoral subjects. ICC was founded in 1919 and today it groups thousands of member companies and associations from over 140 countries.

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