WILMERHALE

Recent Developments in Europe May Influence US Debate on Mandatory Rotation

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Throughout the Public Company Accounting Oversight Board's review of mandatory audit firm rotation, PCAOB Chair James Doty has indicated that the PCAOB will look at how perceived issues of professional independence are being considered internationally. For example, in a February 8, 2013, speech, Mr. Doty stated that the PCAOB would "watch and evaluate the implications of international developments," including EU consideration of mandatory auditor rotation. In the same speech, Mr. Doty also questioned "whether audit committees can be enlisted to monitor and enforce auditor skepticism" as alternatives to structural changes such as mandatory rotation or mandatory tendering (i.e., periodically putting the audit out for bid but not requiring a change of auditors). Noting a recent survey that indicated that only 38% of audit committees claimed to have formal and comprehensive external auditor evaluation processes, he stated that "equipping audit committees to perform the rigorous monitoring that would be needed to test and enforce skepticism would also require a significant change in the way audit committees operate."

In light of Mr. Doty's comments, some recent developments in Europe are of interest:

First, last month the European Parliament's economic affairs committee adopted a proposal for mandatory retendering of the audit engagement every seven years for significant public companies. Companies would have to show that they had considered two candidates for the audit and give reasons for the selection, subject to oversight by a national regulator. This proposal, if implemented, would represent a step back from the European Commission's 2011 proposal to require mandatory audit firm rotation every six years (or nine years, if two firms conduct an audit). The Parliament's legal affairs committee has primary responsibility for the EU audit reform legislation, and it has yet to act on it.

Additionally, in February, the UK Competition Commission issued a report on an investigation into the market for audit services for large public companies in the UK. The report found that the overwhelming majority of these companies are audited by one of the "Big Four" accounting firms. The report concluded that competition in the audit market is restricted by factors which inhibit companies from switching auditors and by a tendency for auditors to focus on satisfying management rather than shareholder needs. (The Commission's findings are summarized here.)

The Commission is now considering ways to encourage greater competition, including mandatory tendering and rotation; increasing information and transparency with more frequent external audit quality reviews and expanding reporting in audit reports or the audit committee report; and strengthening accountability and independence by giving audit committees and shareholders greater control of external audit.

Interestingly, among the many matters discussed in its 300-page report, the Commission stated that there are limitations on the ability of the audit committee, in particular, the audit committee chair, “at least in its current incarnation, to ensure audit quality and independence of the auditor.” The report provided various reasons for this conclusion. Among others, it questioned whether the audit committee chair’s “high-level, supervisory role” enabled it to ensure that auditors responded to shareholder needs rather than management demands. It also implied that audit committee chairs’ time commitments may not be sufficient to oversee complex audits.