Reality check

with Bernadette Barber

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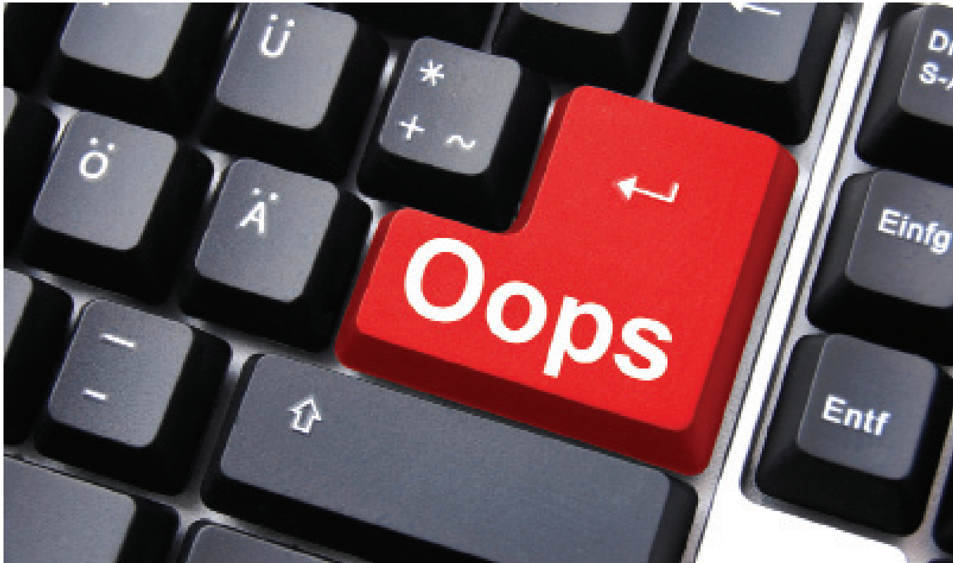
Time for a change?



Auditors, like the rest of humankind, sometimes make mistakes.

EC proposals to force, amongst other things, auditor rotation, threaten to shake up the apparently cosy world of external audit.

Boards of directors have a very personal interest in ensuring that there is a rigorous audit process in place to assist them in meeting their financial reporting obligations. It is somewhat surprising then that the perception is that boards are perhaps too soft on their auditors, allowing them to continue in the role ad infinitum and arguably paying only lip-service to guidelines which advocate regular, comprehensive and disciplined reviews of their external audit firm.

It is certainly astounding, given the universally-accepted wisdom that the review of external audit engagements must be thorough and robust, that so few reviews culminate in a change of auditors. FTSE 100 companies are apparently so happy with their auditors that on average they only switch to a new firm once every 48 years! Such longevity of appointment seems so incongruous in a corporate world, where 'jobs for life' have long-since been consigned to the history books.

Let's face it, for large complex groups, the scale of the task of changing auditor would be daunting for all but the bravest of Finance Directors. Perhaps it's all too easy to find excuses to stick with current audit arrangements and avoid the upheaval which moving to new auditors would surely entail.

In reality, while the rationale for retaining an existing audit firm will vary, compiling a list of sound business reasons for doing so is often not difficult. Perhaps the incumbent auditor has acquired extensive knowledge of a complex group, which would be difficult for another firm to replicate in the medium term, or no other firm possesses adequate sector-specific expertise. Timing can also be a problem, companies can be reluctant to deal with settling in a new auditor alongside managing a period of significant corporate change.

In any case, with evidence to suggest that problems, for example needing to re-state accounts, are more likely to occur in the early years of an auditor's appointment than they are later on, it is perhaps not so surprising that boards are wary of making the leap.

An easier option in the face of such difficulties is to address threats to auditor independence and objectivity by accepting regular rotation of the audit partner, rather than the firm itself, and by enforcing appropriate policies restricting non-audit services and other potential conflicts of interest. Whether such safeguards can be sufficient is one of those judgments which can only be made with the benefit of hindsight. Company collapses not anticipated in accounts, which paint a rosy picture of corporate happiness, tend to be viewed as the exceptions which prove the rule.

The EC proposals coincide with a Competition Commission investigation into the 'big four' UK audit firms, which operate an effective oligopoly when it comes to auditing the UK's largest companies. Between them they earn 99% of FTSE 100 audit fees, not to mention the significant non-audit fees they also make. This limited competition does nothing to dispel the assumption that, in arguing against the EC proposals, these influential firms are thinking of nothing more than protecting their own comfortable position.

Care should be taken though in jumping to the conclusion the audit firms' view of the proposals is incorrect simply because a desire for self-preservation may have influenced their response. Switching auditor only once every 48 years may be excessive but it is a reflection of the extent of the cost and disruption to the business which such a change involves. For a business to have to make that change every six years, as proposed by the EC, could easily outweigh the benefits. The Financial Reporting Council has suggested auditors should be changed every ten years but, whatever the appropriate rotation period should be, it seems unlikely that this is an issue which will simply go away.

Auditors, like the rest of humankind, sometimes make mistakes. The extent to which the accounts they audit are relied upon by others means that those mistakes can have far-reaching consequences and it is not difficult therefore to see that there is a legitimate public interest in securing the best possible external audit processes. What cannot be hoped for though, is that any audit process or regulation can guarantee perfect financial reporting. Finding a balance therefore, as in so many things, must be the objective.

About the author

Bernadette Barber is the author of *ICSA's Corporate Governance Handbook,* published by ICSA Publishing. Order your copy at *www.icsabookshop.co.uk*.