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Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services

November 2003

PUBLIC ACCOUNTING FIRMS

Required Study on the Potential Effects of Mandatory Audit Firm Rotation

GAO

Accountability ★ Integrity ★ Reliability

GAO-04-216

GAO Highlights

Highlights of GAO-04-216, a report to Senate Committee on Banking, Housing, and Urban Affairs and House Committee on Financial Services

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Why GAO Did This Study

Following major failures in corporate financial reporting, the Sarbanes-Oxley Act of 2002 was enacted to protect investors through requirements intended to improve the accuracy and reliability of corporate disclosures and to restore investor confidence. The act included reforms intended to strengthen auditor independence and to improve audit quality. Mandatory audit firm rotation (setting a limit on the period of years a public accounting firm may audit a particular company's financial statements) was considered as a reform to enhance auditor independence and audit quality during the congressional hearings that preceded the act, but it was not included in the act. The Congress decided that mandatory audit firm rotation needed further study and required GAO to study the potential effects of requiring rotation of the public accounting firms that audit public companies registered with the Securities and Exchange Commission.

www.gao.gov/cgi-bin/getrpt?GAO-04-216.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Jeanette M. Franzel at (202) 512-9471 or franzelj@gao.gov.

What GAO Found

The arguments for and against mandatory audit firm rotation concern whether the independence of a public accounting firm auditing a company's financial statements is adversely affected by a firm's long-term relationship with the client and the desire to retain the client. Concerns about the potential effects of mandatory audit firm rotation include whether its intended benefits would outweigh the costs and the loss of company-specific knowledge gained by an audit firm through years of experience auditing the client. In addition, questions exist about whether the Sarbanes-Oxley Act requirements for reform will accomplish the intended benefits of mandatory audit firm rotation.

In surveys conducted as part of our study, GAO found that almost all of the largest public accounting firms and Fortune 1000 publicly traded companies believe that the costs of mandatory audit firm rotation are likely to exceed the benefits. Most believe that the current requirements for audit partner rotation, auditor independence, and other reforms, when fully implemented, will sufficiently achieve the intended benefits of mandatory audit firm rotation. Moreover, in interviews with other stakeholders, including institutional investors, stock market regulators, bankers, accountants, and consumer advocacy groups, GAO found the views of these stakeholders to be consistent with the overall views of those who responded to its surveys.

GAO believes that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional financial costs and the loss of institutional knowledge of the public company's previous auditor of record, as well as the current reforms being implemented. The potential benefits of mandatory audit firm rotation are harder to predict and quantify, though GAO is fairly certain that there will be additional costs.

Several years' experience with implementation of the Sarbanes-Oxley Act's reforms is needed, GAO believes, before the full effect of the act's requirements can be assessed. GAO therefore believes that the most prudent course of action at this time is for the Securities and Exchange Commission and the Public Company Accounting Oversight Board to monitor and evaluate the effectiveness of existing requirements for enhancing auditor independence and audit quality.

GAO believes audit committees, with their increased responsibilities under the act, can also play an important role in ensuring auditor independence. To fulfill this role, audit committees must maintain independence and have adequate resources. Finally, for any system to function effectively, there must be incentives for parties to do the right thing, adequate transparency over what is being done, and appropriate accountability if the right things are not done.

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Abbreviations

AICPA	American Institute of Certified Public Accountants
CGAA	Co-ordinating Group on Audit and Accounting Issues
CNMV	Comision Nacional del Mercaso de Valores
CONSOB	Commissione Nazionale per le Societa e la Borsa
CVM	Comissao de Valores Mobiliarios
EDGAR	Electronic Data Gathering, Analysis, and Retrieval
G-7	Group of Seven Industrialized Nations
GAAP	generally accepted accounting principles
GAAS	generally accepted auditing standards
IOSCO	International Organization of Securities Commissions
NIvRA	Royal Nederlands Instituut van Register Accountants
NOvAA	Nederlandse Orde van Accountants-Administratieconsulenten
OSFI	Office of the Superintendent of Financial Institutions
PCAOB	Public Company Accounting Oversight Board
POB	Public Oversight Board
SEC	Securities and Exchange Commission
SECPS	SEC Practice Section

United States General Accounting Office
Washington, D.C. 20548

November 21, 2003

The Honorable Richard C. Shelby
Chairman
The Honorable Paul S. Sarbanes
Ranking Minority Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Michael G. Oxley
Chairman
The Honorable Barney Frank
Ranking Minority Member
Committee on Financial Services
House of Representatives

Full, fair, and accurate reporting of financial information by public companies[1] is critical to the effective functioning of the capital and credit markets in the United States. Federal securities laws and regulations require publicly owned companies to disclose financial information in a manner that accurately depicts the results of company activities and require that the companies' financial statements be audited by an independent public accountant. Although public company management is responsible for the company's financial statements, public confidence in the integrity of financial statements of publicly traded companies is enhanced by the audit process and independence of the auditor from the audit client.

Major failures in corporate financial reporting in recent years, including accountability breakdowns at Enron and WorldCom and other major corporations, that led to restatement of financial statements and bankruptcy adversely affected thousands of shareholders and employees. As a result, the Sarbanes-Oxley Act of 2002[2] was enacted to protect investors by improving the accuracy and reliability of corporate disclosures. The act's requirements included reforms to strengthen

[1] For purposes of this report, public companies refers to issuers, the securities of which are registered under 15 U.S.C. § 78l, that are required to file reports under 15 U.S.C. § 780 (d), or that file or have filed a registration statements that have not yet become effective under the Securities Act of 1933.

[2] Pub. L. No. 107-204, 116 Stat. 745.

corporate responsibility for financial reports and auditor independence and created the Public Company Accounting Oversight Board (PCAOB). The PCAOB has the responsibility to register and inspect public accounting firms that audit public companies, and the authority to investigate and discipline registered public accounting firms and to set auditing and related attestation, quality control, and auditor ethics and independence standards in connection with audits of public companies.

Senate report 107-205 that accompanied the Sarbanes-Oxley Act stated that in considering reforms to enhance auditor independence, some witnesses believed that mandatory audit firm rotation[3] of public accounting firms was necessary to maintain the objectivity of audits, while other witnesses believed that public accounting firm rotation could be disruptive to the public company and the costs of mandatory audit firm rotation might outweigh the benefits. The Congress decided that mandatory audit firm rotation needed further study and required in Section 207 of the Sarbanes-Oxley Act that GAO study the issues. Specifically, we were asked to study the potential effects of requiring mandatory rotation of registered public accounting firms.[4] To conduct our study, we did the following:

- Identified and reviewed research studies and other documents that addressed issues concerning auditor independence and audit quality associated with the length of a public accounting firm's tenure and the costs and benefits of mandatory audit firm rotation.

- Analyzed the issues we identified to (1) develop detailed questionnaires to obtain the views of public accounting firms and public company chief financial officers and their audit committee chairs of the issues associated with mandatory audit firm rotation, (2) hold discussions with officials of other interested stakeholders, such as institutional investors, federal banking regulators, U.S. stock exchanges, state boards of accountancy, the American Institute of Certified Public Accountants

[3] Mandatory rotation is defined in the Sarbanes-Oxley Act as the imposition of a limit on the period of years in which a particular public accounting firm registered with the PCAOB may be the auditor of record for a particular public company. For purposes of this report, the auditor of record is the public accounting firm issuing an audit opinion of the public company's financial statements.

[4] Section 102 of the Sarbanes-Oxley Act requires public accounting firms that want to audit public companies to register with the PCAOB and states that it shall be unlawful for any person who is not a registered public accounting firm to prepare, issue, or participate in the preparation or issuance of any audit report with respect to any issuer.

(AICPA), the Securities and Exchange Commission (SEC), and the PCAOB to obtain their views on the issues associated with mandatory audit firm rotation, and (3) obtain information from other countries on their experiences with mandatory audit firm rotation.

- Identified restatements of annual financial statements for Fortune 1000 public companies due to errors or fraud that were reported to the SEC for years 2001 and 2002 through August 31, 2003, to (1) determine whether the restatement occurred after a change in the public companies' auditor of record, and (2) to obtain some insight into the value of a "fresh look" by a new auditor of record.

Our population of public accounting firms consisted of three tiers: Tier 1 firms included 92 public accounting firms that were members of the AICPA's self-regulatory program for audit quality that reported having 10 or more SEC clients in 2001 and 5 public accounting firms that were not members of the AICPA's self-regulatory program but had 10 or more public company clients registered with the SEC in 2001.[5] Tier 2 firms included 604 public accounting firms that were members of the AICPA's self-regulatory program for audit quality that reported having 1 to 9 public company clients registered with the SEC in 2001.[6] Tier 3 firms included 421 public accounting firms that were members of the AICPA's self-regulatory program for audit quality that reported having no public company clients registered with the SEC in 2001. We surveyed 100 percent of the 97 Tier 1, firms and we administered our surveys to random samples of 282 of the 604 Tier 2 firms and 237 of the 421 Tier 3 firms. We received responses from 74 of the 97 Tier 1 firms, or 76.3 percent.[7] Because of the more limited participation of Tier 2 firms (85, or 30.1 percent) and Tier 3 firms (52, or 21.9 percent) in our survey, we are not projecting their responses to the population of these firms. The presentation of this report focuses on the

[5] The 92 Tier 1 firms with 10 or more public company clients represented about 90 percent of the total public company clients reported by member firms in their 2001 annual reports to the AICPA's former self-regulatory program for audit quality. Hereafter in this report, "Tier 1 firms" refers to the 97 firms that had 10 or more public company clients.

[6] The 604 Tier 2 firms with 1 to 9 public company clients in 2001 represented about 10 percent of the total public company clients reported by member firms in their 2001 annual reports to the AICPA's former self-regulatory program for audit quality.

[7] Estimates of Tier 1 firms are subject to sampling errors of no more than plus or minus 7 percentage points (95 percent confidence level) unless otherwise noted, as well as to possible nonsampling errors generally found in surveys.

responses from the Tier 1 firms, but any substantial differences in their overall views and those reported to us by either the Tier 2 or 3 firms that responded to our survey is discussed where applicable.

We also drew random samples of 330 of the Fortune 1000 public companies[8] after removing 40 private companies from the list, 450 of the 14,887 other domestic companies and mutual funds, and 391 of 2,141 foreign companies that make up the universe of the 17,988 public companies that are registered with the SEC as of February 2003. For each of these three groups of public companies, we asked their chief financial officers and audit committee chairs to complete separate questionnaires.

Of the 330 Fortune 1000 public companies sampled, we received responses from 201, or 60.9 percent, of their chief financial officers and 191, or 57.9 percent, of their audit committee chairs.[9] Because of limited participation of the other domestic companies and mutual funds (131, or 29.1 percent, of their chief financial officers and 96, or 21.3 percent, of their audit committee chairs) and the foreign public companies (99, or 25.3 percent, of their chief financial officers and 63, or 16.1 percent, of their audit committee chairs), we are not projecting their responses to the population of such companies. This report focuses on the responses from the Fortune 1000 public companies' chief financial officers and their audit committee chairs, but any substantial differences between their overall views and those reported to us by the other groups of public companies that responded to our surveys is discussed where applicable.

For additional information on our scope and methodology including details of our samples, response rates, and efforts to follow up with nonrespondents to our surveys, see appendix I. We conducted our work in Washington, D.C., between November 2002 and November 2003 in accordance with U.S. generally accepted government auditing standards.

[8] We removed 40 private companies from the list of Fortune 1000 public companies. Therefore, our population of Fortune 1000 public companies was 960.

[9] The estimates from these surveys are subject to sampling errors of no more than plus or minus 6 percentage points (95 percent confidence level) unless otherwise noted, as well as to possible nonsampling errors generally found in surveys.

A copy of each of our questionnaires, annotated to show in total the respondents' answers to each question for the Tier 1 firms and the Fortune 1000 public companies chief financial officers[10] and their audit committee chairs, will be presented in a separate GAO report (GAO-04-217) to be issued at a later date.

Results in Brief

Nearly all Tier 1 firms and Fortune 1000 public companies and their audit committee chairs believed that the costs of mandatory audit firm rotation are likely to exceed the benefits. Also, most Tier 1 firms and Fortune 1000 public companies and their audit committee chairs believe that either the audit firm partner rotation requirements of the Sarbanes-Oxley Act as implemented by the SEC, or those partner rotation requirements coupled with other requirements of the Sarbanes-Oxley Act that concern auditor independence and audit quality, will sufficiently achieve the benefits of mandatory audit firm rotation when fully implemented. Our discussions with a number of other knowledgeable individuals in a variety of fields, such as institutional investment; regulation of the stock markets, the banking industry, and the accounting profession; and consumer advocacy, showed that most of the individuals we spoke with held views consistent with the overall views expressed by those who responded to our surveys.

Considering the arguments for and against mandatory audit firm rotation and the requirements of the Sarbanes-Oxley Act concerning auditor independence and audit quality, which are also intended to achieve the same type of benefits as mandatory audit firm rotation, we believe that more experience needs to be gained with the act's requirements. Therefore, the most prudent course at this time is for the SEC and the PCAOB to monitor and evaluate the effectiveness of the act's requirements to determine whether further revisions, including mandatory audit firm rotation, may be needed to enhance auditor independence and audit quality to protect the public interest.

Our research of studies concerning issues related to mandatory audit firm rotation showed the primary arguments relate to auditor independence, audit quality, audit cost, and competition-related issues for providing audit services. Regarding auditor independence and audit quality issues, our

[10] Hereafter, "Fortune 1000 public companies" refers to their chief financial officers.

analysis of survey results of Tier 1 firms and Fortune 1000 public companies showed the following:

- The average length of the auditor of record's tenure, which proponents of mandatory audit firm rotation believe increases the risk that auditor independence and ultimately audit quality may be adversely affected, was about 22 years for Fortune 1000 public companies.

- About 79 percent of Tier 1 firms and Fortune 1000 public companies believe that changing audit firms increases the risk of an audit failure in the early years of the audit as the new auditor acquires the necessary knowledge of the company's operations, systems, and financial reporting practices and therefore may fail to detect a material financial reporting issue.

- Most Tier 1 firms and Fortune 1000 public companies believe that mandatory audit firm rotation would not have much effect on the pressures faced by the audit engagement partner in appropriately dealing with material financial reporting issues.

- About 59 percent of Tier 1 firms reported they would likely move their most knowledgeable and experienced audit staff as the end of the firm's tenure approached under mandatory audit firm rotation to attract or retain other clients, which they acknowledged would increase the risk of an audit failure.

Regarding audit costs, our survey results show that Tier 1 firms and Fortune 1000 public companies expect that mandatory audit firm rotation would lead to more costly audits.

- Nearly all Tier 1 firms estimated that initial year audit costs under mandatory audit firm rotation would increase by more than 20 percent over subsequent year costs to acquire the necessary knowledge of the public company and most of the Tier 1 firms estimated their marketing costs would also increase by at least more than 1 percent, which would be passed on to the public companies.

- Most Fortune 1000 public companies estimated that under mandatory audit firm rotation, they would incur auditor selection costs and additional auditor support costs totaling at least 17 percent or higher as a percentage of initial year audit fees.

Our check of audit fees and total company operating expenses reported by a selection of large and small public companies in 23 industries for the most recent fiscal year available found that for the large public companies selected, average audit fees represented approximately 0.04 percent of company operating expenses and, for the small public companies selected, average audit fees represented approximately 0.08 percent of company operating expenses. Based on estimates of possible increased audit-related costs from survey responses from Tier 1 firms and Fortune 1000 public companies, mandatory audit firm rotation could increase these audit-related costs from 43 percent to 128 percent of the recurring annual audit fees. This illustration is intended only to provide some insight into how, based on Tier 1 firms' and Fortune 1000 public companies' responses, mandatory audit firm rotation may affect the initial year audit-related costs public companies may incur and is not intended to be representative.

Regarding competition-related effects of mandatory audit firm rotation, 54 percent of Tier 1 firms believe mandatory audit firm rotation would decrease the number of firms willing and able to compete for audits of public companies and 83 percent of Tier 1 firms believe that the market share of public company audits would either become more concentrated in a small number of public accounting firms or would remain the same. As we have previously reported,[11] the number of public accounting firms providing audit services to public companies is highly concentrated with the 4 largest firms auditing over 78 percent of all U.S. public companies and 99 percent of public company sales. Many Fortune 1000 public companies reported that they will only use a Big 4 firm for a variety of reasons, including the capability of the firms to provide them audit services and the expectations of the capital markets that they will use Big 4 firms. Mandatory audit firm rotation would further decrease their choices for an auditor of record, and the Sarbanes-Oxley Act auditor independence requirements concerning prohibited nonaudit services may also further limit the public companies' choices for an auditor of record. Tier 1 firms expected that public companies in specialized industries, which in some industries currently have more limited choices for an auditor of record than other public companies, could be more affected by mandatory audit firm rotation than other public companies.

[11] U.S. General Accounting Office, *Public Accounting Firms: Mandated Study on Consolidation and Competition*, GAO-03-864 (Washington, D.C.: July 30, 2003).

We believe that mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality considering the additional financial costs and the loss of institutional knowledge of a public company's previous auditor of record. The potential benefits of mandatory audit firm rotation are harder to predict and quantify, though we are fairly certain that there will be additional costs. In addition, the current reforms being implemented may also provide some of the intended benefits of mandatory audit firm rotation. In that respect, mandatory audit firm rotation is not a panacea that totally removes the pressures on the auditors in appropriately resolving financial reporting issues that may materially affect the public companies' financial statements. These inherent pressures are likely to continue even if the term of the auditor is limited under any mandatory rotation process. Furthermore, most public companies will only use the Big 4 firms for audit services. Given this preference, these public companies may only have 1 or 2 real choices for auditor of record under any mandatory rotation system given the importance of industry expertise and the Sarbanes-Oxley Act's auditor independence requirements. However, over time a mandatory audit firm rotation requirement may result in more firms transitioning into additional industry sectors if the market for such audits has sufficient profit margins.

The Sarbanes-Oxley Act contains significant reforms aimed at enhancing auditor independence (e.g., additional partner rotation requirements and restrictions on providing nonaudit or consulting services) and audit quality (e.g., establishing the PCAOB and management and auditor reporting on internal controls over financial reporting) that are also intended to achieve the same type of benefits as mandatory audit firm rotation. The PCAOB's inspection program for registered public accounting firms could also provide an opportunity to provide a "fresh look", which would enhance auditor independence and audit quality through the program's inspection activities and also may provide new insights regarding (1) public companies' financial reporting practices that pose a high risk of issuing materially misstated financial statements for the audit committees to consider and (2) possibly either using the auditor of record or another firm to assist in reviewing these areas. However, it will take at least several years for the SEC and the PCAOB to gain sufficient experience with the effectiveness of the act in order to adequately evaluate whether further enhancements or revisions, including mandatory audit firm rotation, may be needed to further protect the public interest and to restore investor confidence. The current environment has greatly increased the pressures on public company management and auditors regarding honest, fair, and complete financial reporting, but it is uncertain if the current climate will be sustained over the long term. Rigorous enforcement of the act's requirements will undoubtedly be critical to its effectiveness.

We also believe that audit committees with their increased responsibilities under the Sarbanes-Oxley Act can play a very important role in enhancing auditor independence and audit quality. In that respect, the Conference Board Commission on Public Trust and Private Enterprise stated in its January 9, 2003, report that auditor rotation is a useful tool for building shareholder confidence in the integrity of the audit and of the company's financial statements. The commission advocated that audit committees should consider rotating audit firms when there are circumstances that could call into question the audit firm's independence from management. These circumstances included when (1) significant nonaudit services are provided by the auditor of record to the company (even if approved by the audit committee), (2) one or more former partners or managers of the audit firm are employed by the company, or (3) lengthy tenure of the auditor of record, such as over 10 years—which our survey results show is prevalent at many Fortune 1000 public companies. We believe audit committees that encounter these circumstances, at a minimum, need to be especially vigilant in the oversight of the auditor and in considering whether a "fresh look" (e.g., new auditor) is needed. We also believe that if audit committees regularly evaluated whether audit firm rotation would be beneficial, given the facts and circumstances of their companies' situation, and are actively involved in helping to ensure auditor independence and audit quality, many of the benefits of audit firm rotation could be realized at the initiative of the audit committees rather than through a mandatory rotation requirement.

In order to be effective, however, audit committees need to have access to adequate resources, including their own budgets, to be able to operate with the independence necessary to effectively perform their responsibilities under the Sarbanes-Oxley Act. Further, we believe that the audit committee's ability to operate independently is directly related to the independence of the public company's board of directors. It is not realistic to believe that an audit committee will unilaterally resolve financial reporting issues that materially affect a public company's financial statements without vetting those issues with the board of directors. Also, the ability of the board of directors to operate independently may also be affected in corporate governance structures where the public company's chief executive officer also serves as the chair of the board of directors. Like audit committees, boards of directors also need to be independent and have adequate resources and access to independent attorneys and other advisors when they believe it is appropriate. Finally, for any system to function effectively, there must be incentives for parties to do the right thing, adequate transparency to provide reasonable assurance that people will do the right thing, and appropriate accountability when people do not do the right thing.

This report makes no recommendations. We provided copies of a draft of this report to the SEC, AICPA, and PCAOB for their review. Representatives of the AICPA and the PCAOB provided technical comments, which we have incorporated where applicable. Representatives of the SEC had no comments.

Background

Under federal securities laws, public companies are responsible for the preparation and content of financial statements that are complete, accurate, and presented in conformity with generally accepted accounting principles (GAAP). Financial statements, which disclose a company's financial position, stockholders' equity, results of operations, and cash flows, are an essential component of the disclosure system on which the U.S. capital and credit markets are based.

The Securities Exchange Act of 1934 requires that a public company's financial statements be audited by an independent public accountant. That statutory independent audit requirement in effect granted a franchise to the nation's public accountants, as an audit opinion on a public company's financial statements must be secured before an issuer of securities can go to market, have the securities listed on the nation's stock exchanges, or comply with the reporting requirements of the securities laws. As of February 2003, there were about 17,988 public companies that were registered with the SEC and subject to the federal securities laws (15,847 domestic and 2,141 foreign public companies). Based on 2001 annual reports of public accounting firms submitted to the AICPA, about 700 public accounting firms that were members of the AICPA's former self-regulatory program for audit quality reported having approximately 15,000 public company clients registered with the SEC, of which the Big 4 public accounting firms[12] had about 70 percent of these public company clients and another 88 public accounting firms had about 20 percent of these

[12] PricewaterhouseCoopers LLP, Ernst & Young LLP, Deloitte & Touche LLP, and KPMG LLP.

public company clients. The other approximately 600 public accounting firms had the remaining 10 percent of the reported public company clients.

The independent public accountant's audit is critical in the financial reporting process because the audit subjects financial statements, which are management's responsibility, to scrutiny on behalf of shareholders and creditors to whom management is accountable. The auditor is the independent link between management and those who rely on the financial statements.

Ensuring auditor independence—both in fact and appearance—is a long-standing issue. There has long been an arguably inherent conflict in the fact that an auditor is paid by the public company for which the audit was being performed. Various study groups over the past 20 years have considered the independence and objectivity of auditors as questions have arisen from (1) significant litigation involving auditors, (2) the auditor's performance of nonaudit services for audit clients, which prior to the Sarbanes-Oxley Act, had risen to 50 percent of total revenues on average for the large accounting firms,[13] (3) "opinion shopping" by clients, and (4) reports of public accountants advocating questionable client positions on accounting matters.

The major accountability breakdowns at Enron and WorldCom, and other failures in recent years such as Qwest, Tyco, Adelphia, Global Crossing, Waste Management, Micro Strategy, Superior Federal Savings Bank, and Xerox, led to the reforms contained in the Sarbanes-Oxley Act to enhance auditor independence and audit quality and to restore investor confidence in the nation's capital markets. To enhance auditor independence and audit quality, the act's reforms included

- establishing the PCAOB, as an independent nongovernmental entity, to oversee the audit of public companies that are subject to the securities laws;
- making the PCAOB responsible for (1) establishing auditing and related attestation, quality control, ethics, and independence standards applicable to audits of public companies, (2) conducting inspections, investigations, and disciplinary proceedings of public accounting firms registered with the PCAOB, and (3) imposing appropriate sanctions;

[13] Senate Report 107-205, at 14 (2002).

- making the public company's audit committee responsible for the appointment, compensation, and oversight of the registered public accounting firm;

- requiring management and auditors' reports on internal control over financial reporting;

- prohibiting the registered public accounting firm from providing certain nonaudit services to a public company if the auditor is also providing audit services;

- requiring the audit committee to preapprove all audit and nonaudit services not otherwise prohibited;

- requiring mandatory rotation of lead and reviewing audit partners after they have provided audit services to a particular public company for 5 consecutive years; and

- prohibiting the public accounting firm from providing audit services if the public company's chief financial officer, chief accounting officer, or any person serving in an equivalent position was employed by the firm and participated in the audit of the public company during the 1-year period preceding the date of starting the audit.

Mandatory audit firm rotation was also discussed in congressional hearings to enhance auditor independence and audit quality, but given the mixed views of various stakeholders, the Congress decided the effects of such a practice needed further study.

Pros and Cons of Requiring Mandatory Audit Firm Rotation

Our review of research studies, technical articles, and other publications and documents showed that generally the arguments for and against mandatory audit firm rotation concern auditor independence, audit quality,[14] and increased audit costs. A breakdown in auditor independence or audit quality can result in an audit failure and adversely affect those parties who rely on the fair presentation of the financial statements in conformity with GAAP.

Those who support mandatory audit firm rotation contend that pressures faced by the incumbent auditor to retain the audit client coupled with the auditor's comfort level with management developed over time can adversely affect the auditor's actions to appropriately deal with financial reporting issues that materially affect the company's financial statements. Those who oppose audit firm rotation contend that the new auditor's lack of knowledge of the company's operations, information systems that support the financial statements, and financial reporting practices and the time needed to acquire that knowledge increase the risk of an auditor not detecting financial reporting issues that could materially affect the company's financial statements in the initial years of the new auditor's tenure, resulting in financial statements that do not comply with GAAP.

In addition, those who oppose mandatory audit firm rotation believe that it will increase costs incurred by both the public accounting firms and the public companies. They believe the increased risk of an audit failure and the added costs of audit firm rotation outweigh the value of a periodic "fresh look" by a new public accounting firm. Conversely, those who support audit firm rotation believe the value of the "fresh look" to protect shareholders, creditors, and other parties who rely on the financial

[14] Audit quality as used in this report refers to the auditor conducting the audit in accordance with generally accepted auditing standards (GAAS) to provide reasonable assurance that the audited financial statements and related disclosures are (1) presented in conformity with GAAP and (2) are not materially misstated whether due to errors or fraud. This definition assumes that reasonable third parties with knowledge of the relevant facts and circumstances would have concluded that the audit was conducted in accordance with GAAS and that, within the requirements of GAAS, the auditor appropriately detected and then dealt with known material misstatements by (1) ensuring that appropriate adjustments, related disclosures, and other changes were made to the financial statements to prevent them from being materially misstated, (2) modifying the auditor's opinion on the financial statements if appropriate adjustments and other changes were not made, or (3) if warranted, resigning as the public company's auditor of record and reporting the reason for the resignation to the SEC.

statements outweigh the added costs associated with mandatory firm rotation.

More recently, the Sarbanes-Oxley Act's requirements that concern auditor independence and audit quality have added to the mixed views about whether mandatory audit firm rotation should also be required to enhance auditor independence and audit quality.

Results of Our Surveys

The results of our surveys show that while auditor tenure at Fortune 1000 public companies averages 22 years, about 79 percent of Tier 1[15] firms and Fortune 1000 public companies[16] are concerned that changing public accounting firms increases the risk of an audit failure in the initial years of the audit as the new auditor acquires the knowledge of a public company's operations, systems, and financial reporting practices. Further, many Fortune 1000 public companies will only use Big 4 public accounting firms and believe that the limited choices, that are likely to be further reduced by the auditor independence requirements of the Sarbanes-Oxley Act, coupled with the likely increased costs of financial statement audits and increased risk of an audit failure under mandatory audit firm rotation strongly argue against the need for mandatory rotation.

In addition, most Tier 1 firms and Fortune 1000 public companies believe that the pressures faced by the incumbent auditor to retain the client are not a significant factor adversely affecting the auditor appropriately dealing with financial reporting issues that may materially affect a public company's financial statements. Most Tier 1 firms, and nearly all Fortune 1000 public companies, and their audit committee chairs believe that the Sarbanes-Oxley Act's requirements concerning auditor independence and audit quality, when fully implemented, will sufficiently achieve the intended benefits of mandatory audit firm rotation, and therefore, they believe it would be premature to impose mandatory audit firm rotation at this time.

Finally, about 50 percent of Tier 1 firms and 62 percent of Fortune 1000 public companies stated that mandatory audit firm rotation would have no

[15] Hereafter, the presentation of our detailed Tier 1 firm survey results represent estimated projections to their population.

[16] Hereafter, the presentation of our detailed Fortune 1000 public companies' and their audit committee chairs' survey results represent estimated projections to their populations.

effect on the perception of auditor independence held by the capital markets and institutional investors. However, 65 percent of Fortune 1000 public companies reported that individual investors' perception of auditor independence would be increased, while the Tier 1 firms had mixed views on the effect on individual investors' perceptions. At the same time, most Tier 1 firms reported that mandatory audit firm rotation may negatively affect audit assignment staffing, causing an increased risk of audit failures, and may create some confusion as currently a change in a public company's auditor of record sends a "red flag" signal as to why the change may have occurred. In contrast, most Fortune 1000 public companies did not believe scheduled changes in the auditor of record would result in a "red flag" signal.

Auditor of Record Tenure, Independence, and Audit Quality

Currently, neither the SEC nor the PCAOB has set any regulatory limits on the length of time that a public accounting firm may function as the auditor of record for a public company. Based on the responses to our surveys, we estimate that about 99 percent of Fortune 1000 public companies and their audit committees currently do not have a public accounting firm rotation policy, although we estimate that about 4 percent are considering such a policy. Unlimited tenure and related pressure on the public accounting firm and applicable partner responsible for providing audit services to the company to retain the client and the related continuing revenues are factors cited by those who support mandatory audit firm rotation. They believe that periodically having a new auditor will bring a "fresh look" to the public company's financial reporting and help the auditor appropriately deal with financial reporting issues since the auditor's tenure would be limited under mandatory audit firm rotation. Those who oppose mandatory audit firm rotation believe that changing auditors increases the risk of an audit failure during the initial years as the new auditor acquires the knowledge of the public company's operations, systems, and financial reporting practices.

The Conference Board's Commission on Public Trust and Private Enterprise[17] in its January 9, 2003, report recommended that audit committees should consider rotating audit firms when there is a combination of circumstances that could call into question the audit firm's independence from management. The Commission believed that the existence of some or all of the following circumstances particularly merit consideration of rotation: (1) significant nonaudit services are provided by the auditor of record to the company—even if they have been approved by the audit committee, (2) one or more former partners or managers of the audit firm are employed by the company, or (3) the audit firm has been employed by the company for a substantial period of time, such as over 10 years.

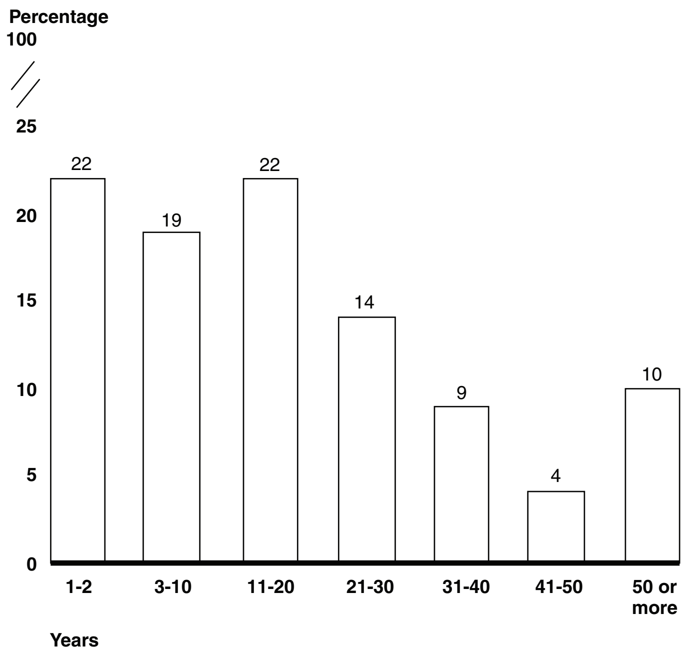
To initially examine the issues surrounding the length of the auditors' tenure, we asked public companies and public accounting firms to provide information on the length of auditor tenure. According to our survey, Fortune 1000 public companies' average auditor tenure is 22 years. Two contrasting factors greatly influence this 22-year average—the recent increased changes in auditors lowered the average and the long audit tenure period associated with approximately 10 percent of Fortune 1000 public companies raised the average. About 20 percent of the Fortune 1000 public companies had their current auditor of record for less than 3 years, a rate of change in auditors over the last 2 years substantially greater than the nearly 3 percent annual change rate historically observed.[18] This increased rate of auditor change was driven largely by the recent dissolution of Arthur Andersen LLP. More than 80 percent of Fortune 1000 public companies that changed auditors over the last 2 years did so to

[17] The Conference Board is a not-for-profit organization that conducts conferences, makes forecasts and assesses trends, publishes information and analysis, and brings executives together to learn from one another. The Conference Board formed the commission to address the circumstances that led to the recent corporate scandals and subsequent decline of confidence in U.S. capital markets. The commission included former senior federal government officials, such as a former Chairman of the Board of Governors of the Federal Reserve System, former Chairman of the SEC, and former Comptroller General; a state government official responsible for the state's retirement system; a former U.S. senator; various private sector executives holding senior positions of responsibility; and a college professor.

[18] R. Doogar (University of Illinois, Urbana-Champaign) and R. Easley and D. Ricchiute (University of Notre Dame), "Switching Costs, Audit Firm Market Shares and Merger Profitability," (Nov. 20, 2001), which was discussed in GAO-03-864, cited a level of 2.7 percent annual client switching of auditors based on prior research the authors performed using 1981-1997 *Compustat* data.

replace Andersen.[19] Increasing the overall average audit tenure period for Fortune 1000 public companies were the approximately 10 percent of public companies that had the same auditing firm for more than 50 years and have an average tenure period of more than 75 years. Excluding those Fortune 1000 public companies that have replaced Andersen in the last 2 years as well as those companies that had the same auditor of record for more than 50 years, the average for the remaining Fortune 1000 public companies is 19 years. See figure 1 for the Fortune 1000 public companies' estimated audit firm tenure.

Figure 1: Estimated Audit Firm Tenure for Fortune 1000 Public Companies



Source: GAO analysis of survey data.

An intended effect of mandatory audit firm rotation is to decrease the existing lengthy auditor tenure periods, thus lessening concerns about the firm's desire to retain a client adversely affecting auditor independence.

[19] The Fortune 1000 public companies that hired a new audit firm to replace Andersen over the last 2 years reported that Andersen had served as their companies' auditor of record for an average of 26 years.

About 97 percent of Fortune 1000 public companies expected that mandatory audit firm rotation would lower the number of consecutive years that a public accounting firm could serve as their auditor of record. The Fortune 1000 public companies were not given a possible limit on the number of years that a public accounting firm could serve as their auditor of record under mandatory audit firm rotation. Therefore, they reported their general belief that mandatory rotation would have the effect of decreasing auditor tenure based on their past experiences.

Impact of Auditor Knowledge and Experience on the Auditor's Detection of Misstatements

Since the new auditor's knowledge and experience with auditing a public company after a change in auditors is a concern, we asked public accounting firms and public companies a number of questions about factors important to detecting material misstatements of financial statements. Tier 1 firms noted that a number of factors affect the auditor's ability to detect financial reporting issues that may indicate material misstatements in a public company's financial statements, including education, training, and experience; knowledge of GAAP and GAAS; experience with the company's industry; appropriate audit team staffing; effective risk assessment process for determining client acceptance; and knowledge of the client's operations, systems, and financial reporting practices.[20] Although each of the above factors affects the quality of an audit, opponents of mandatory audit firm rotation focus on the increased risk of audit failure that may result from the new auditor's lack of specific knowledge of the client's operations, systems, and financial reporting practices. Based on the responses to our survey, we estimated that about 95 percent of Tier 1 firms would rate such specific knowledge as either of very great importance or great importance in the auditor's ability to detect financial reporting issues that may indicate material misstatements in a public company's financial statements.

GAAS require the auditor to obtain a sufficient knowledge of the client's operations, systems, and financial reporting practices to assess audit risk[21] and to gather sufficient competent evidential matter. About 79 percent of

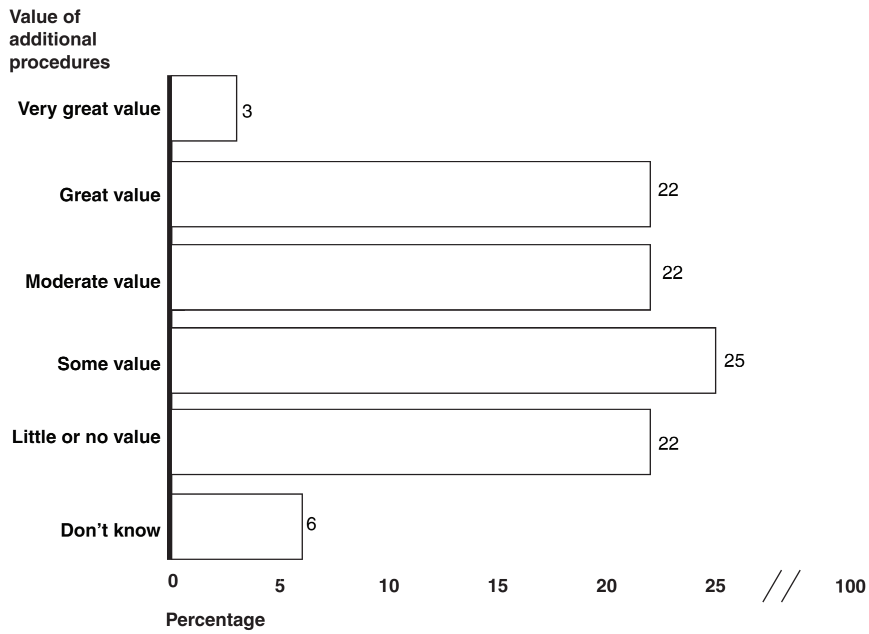
[20] Although not specifically listed in our applicable survey question, several Tier 1 firms commented that public company management's integrity, honesty, and cooperation is of very great or great importance in the auditor's ability to detect material financial reporting issues.

[21] GAAS define audit risk as the risk that an auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.

Tier 1 firms and Fortune 1000 public companies believed that the risk of an audit failure is higher in the early years of audit tenure as the new firm is more likely to not have fully developed and applied an in-depth understanding of the public company's operations and processes affecting financial reporting. More than 83 percent of Tier 1 firms and Fortune 1000 public companies that expressed a view stated that it generally takes 2 to 3 years or more to become sufficiently familiar with the companies' operations and processes before the additional resources often needed to become knowledgeable are no longer needed. Tier 1 firms had mixed views about whether mandatory audit firm rotation (e.g., the "fresh look") would either increase, decrease or have no effect on the new auditor's likelihood of detecting financial reporting issues that may materially affect the financial statements that the previous auditor may not have detected. However, 50 percent of Fortune 1000 public companies reported that mandatory audit firm rotation would have no effect on the auditor's likelihood of detecting such financial reporting issues, while other Fortune 1000 public companies were generally split regarding whether mandatory audit firm rotation would either increase or decrease the auditor's likelihood of detecting such financial reporting issues.

As shown in figure 2, Tier 1 firms had mixed views of the value of additional audit procedures during the initial years of a new auditor's tenure, although 72 percent reported that additional audit procedures would be of at least some value in helping to reduce audit risk to an acceptable level.

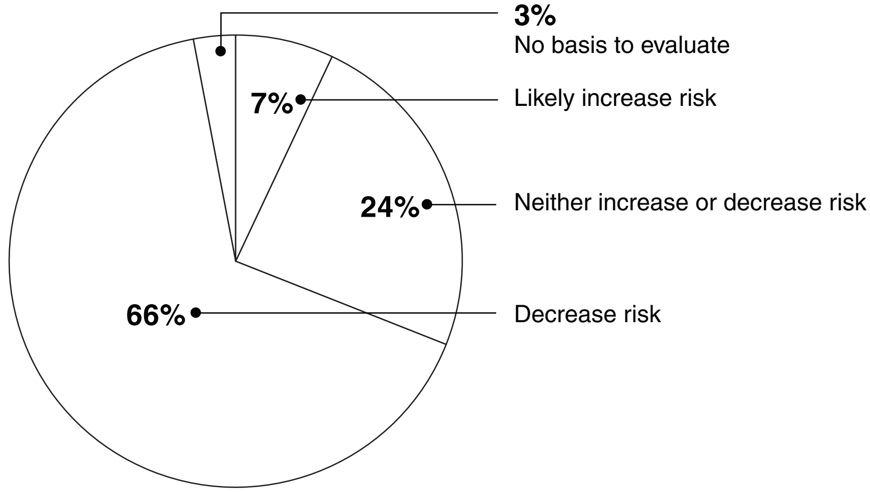
Figure 2: Tier 1 Firms: Value of Additional Procedures When Firm Has Less Knowledge and Experience with a Client



Source: GAO analysis of survey data.

Most Fortune 1000 public companies believed such additional audit procedures would decrease audit risk, as shown in figure 3.

Figure 3: Fortune 1000 Public Companies' Belief That Additional or Enhanced Audit Procedures Would Affect the Risk of Not Detecting Material Misstatements



Source: GAO analysis of survey data.

The Tier 1 firms were also asked about the potential value of having enhanced access to key members of the previous audit team and its audit documentation to help reduce audit risk. The Tier 1 firms generally saw more potential value in having enhanced access to the previous audit team and its audit documentation than in performing additional audit procedures and verification of the public company's data during the initial years of the auditor's tenure. Nearly all of the Tier 1 firms believed that access to the previous audit team and its audit documentation could be accomplished under current GAAS.[22]

[22] Several Tier 1 firms commented that cooperation of the predecessor public accounting firm is a barrier to full access of the firm's audit documentation and indicated that this is an area that the PCAOB may need to address.

Pressures Faced by Firms in Dealing with Financial Reporting Issues

Proponents of mandatory audit firm rotation cite that pressures to retain the client can adversely affect the auditor's decision to appropriately deal with financial reporting issues when public company management is not supportive of the auditor's position on what is required by GAAP. They believe that mandatory audit firm rotation would serve as an incentive for the auditor to take the appropriate action since the auditor would know that tenure as auditor of record and the related revenues are for a limited term.[23]

We asked public accounting firms and public companies based on their experiences whether the auditor's length of tenure is a factor in whether the auditor appropriately deals with material financial reporting issues and whether mandatory audit firm rotation would affect the pressures the firms face. About 69 percent of Tier 1 firms and 73 percent of Fortune 1000 public companies do not believe that the risk of an audit failure increases due to the auditors' long-term relationship with the public companies' management under a long audit tenure and the auditors' desire to retain the clients. About 55 percent of the other Tier 1 firms[24] and 65 percent of the other Fortune 1000 public companies[25] were uncertain whether the risk of an audit failure would increase or decrease due to the auditors' long-term tenure.

About 71 percent of Tier 1 firms and 67 percent of Fortune 1000 public companies believe that pressure on the engagement partner to retain the client is currently small or not a factor in whether the auditor appropriately deals with financial reporting issues that may materially affect a public company's financial statements. However, 28 percent of Tier 1 firms and 33 percent of Fortune 1000 public companies believe such pressures are moderate or stronger. About 18 percent of Tier 1 firms and Fortune 1000 public companies believed that under mandatory audit firm rotation, the pressures on the engagement partner would still be a moderate or stronger

[23] Although mandatory audit firm rotation would likely set a limit on the number of consecutive years the public accounting firm could serve as the company's auditor of record, it may also provide that the business relationship could be terminated by either party during that time.

[24] The 95 percent confidence interval surrounding this estimate ranges from 41 percent to 62 percent.

[25] The 95 percent confidence interval surrounding this estimate ranges from 51 percent to 77 percent.

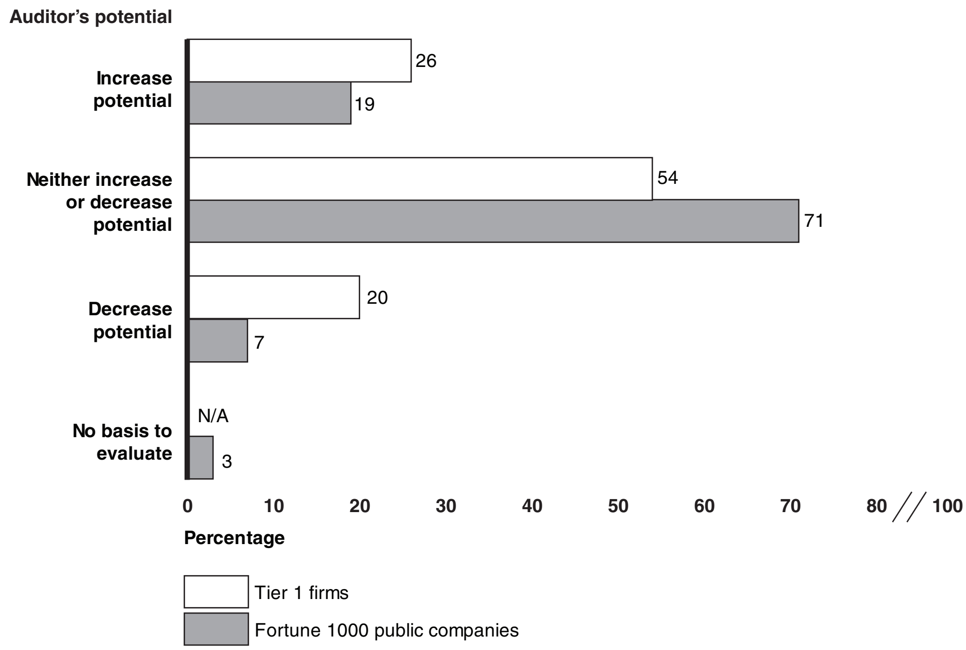
factor in retaining the audit client and in appropriately dealing with financial reporting issues. Therefore, based on these views, mandatory audit firm rotation would likely somewhat reduce the pressures on the engagement partner to retain the client. However, most Tier 1 firms and Fortune 1000 public companies generally considered these pressures to be small or not a factor in the auditor appropriately dealing with material financial reporting issues.

Tier 1 firms and Fortune 1000 public companies expressed similar views, that mandatory audit firm rotation would not significantly change the pressures on the engagement partner to retain the client as a factor in whether the engagement partner appropriately challenges overly aggressive/optimistic financial reporting[26] by management.

As shown in figure 4, overall about 54 percent of Tier 1 firms and 71 percent of Fortune 1000 public companies believe mandatory audit firm rotation overall would have no effect on the new auditor's potential for appropriately dealing with material financial reporting issues.

[26] GAAP are subject to interpretation by public company management and underlying concepts of GAAP may be applied to transactions of a public company that are not specifically addressed by GAAP. The auditor may encounter situations in which public company management aggressively or optimistically applies the concepts of GAAP to achieve a certain result that arguably may not reflect the economic substance of the transactions while public company management believes such financial reporting complies with GAAP.

Figure 4: Views on How Mandatory Audit Firm Rotation Would Affect the Auditor's Potential to Deal with Material Financial Reporting Issues Appropriately



Source: GAO analysis of survey data.

The remaining Tier 1 firms are split between whether mandatory audit firm rotation would increase or decrease their potential to appropriately deal with material financial reporting issues. However, about 67 percent of the remaining Fortune 1000 public companies believe that mandatory audit firm rotation would increase the potential for the new auditor to deal appropriately with such financial reporting issues.[27] In contrast, either with or without mandatory audit firm rotation, about 62 percent of Tier 1 firms and 63 percent of Fortune 1000 public companies believe the potential of a subsequent lawsuit, regulatory action, or both against the public accounting firm and its engagement partner is a moderate or stronger pressure for them to deal appropriately with financial reporting issues that may materially affect a public company's financial statements.

[27] The 95 percent confidence interval surrounding this estimate ranges from 54 percent to 79 percent.

How Mandatory Audit Firm Rotation May Affect Perception of Auditors' Independence

Researchers have also raised questions about how the capital markets' and investors' current perceptions of auditor independence and audit quality would be affected by mandatory audit firm rotation. Under mandatory audit firm rotation, about 52 percent of Tier 1 firms and about 62 percent of Fortune 1000 public companies believed that the current perception of auditor independence held by capital markets and institutional investors would not be affected by requiring mandatory audit firm rotation while 34 percent of Tier 1 firms and about 38 percent of Fortune 1000 public companies believed the perception of auditor independence would increase. However, about 65 percent of Fortune 1000 public companies believed that perception of auditors' independence held by individual investors would more likely increase under mandatory audit firm rotation while the Tier 1 firms had mixed views on the effect on individual investors. See the Overall Views of Other Knowledgeable Individuals on Mandatory Audit Firm Rotation section of the report for the results of our discussions with other knowledgeable individuals, including institutional investors, for their views on how mandatory audit firm rotation may affect their perception of auditor independence.

How Mandatory Audit Firm Rotation May Affect Audit Assignment Staffing

Our research into the effects of mandatory audit firm rotation identified concerns about whether public accounting firms would move their most knowledgeable and experienced audit personnel from the current audit to other audits as the end of their tenure as auditor of record approached in order to attract or retain other clients. In response to our survey questions about whether mandatory audit firm rotation would affect assignment of audit staff, about 59 percent of Tier 1 firms indicated that they would likely move their most knowledgeable and experienced audit staff to other work to enhance the firm's ability to attract or retain other clients and another 28 percent were undecided. Only about 13 percent of Tier 1 firms stated it was unlikely that an accounting firm would move staff to other work. Of the Tier 1 firms that stated they would likely move their most knowledgeable and experienced staff, 86 percent[28] believe that moving these staff would increase the risk of an audit failure. About 92 percent of Fortune 1000 public companies also believed that by moving these audit staff, the risk of an audit failure would be increased.

[28] The 95 percent confidence interval surrounding this estimate ranges from 77 percent to 90 percent.

How Mandatory Audit Firm Rotation May Affect Public Accounting Firms' Investment in Audit Tools

Opponents of mandatory audit firm rotation expressed concern that limited audit tenure under mandatory rotation could cause public accounting firms to not invest in audit tools related to the effectiveness of auditing a specific client or industry. About 76 percent of Tier 1 firms stated that their average audit tenure would likely decrease under mandatory audit firm rotation, and about 97 percent of Fortune 1000 public companies expected the length of their auditors' tenure would decrease compared to their previous experience with changing auditors. In response to our survey questions about this possibility, about 64 percent of these Tier 1 firms said mandatory audit firm rotation would not likely decrease incentives to invest the resources needed to understand the client's operations and financial reporting practices in order to devise effective audit procedures and tools, while 36 percent said it would. Conversely, about 67 percent of Fortune 1000 public companies were concerned that mandatory audit firm rotation could negatively affect incentives for public accounting firms to invest in effective audit procedures and tools.

How Mandatory Audit Firm Rotation May Affect the Current "Red Flag" Signal to Investors When a Change in a Public Company's Auditor of Record Occurs

Currently, when a change in the auditor of record occurs it acts as a "red flag" signal to investors to question why the change occurred and if the change may have occurred because of reasons related to the presentation of the public company's financial statements, such as differences in views of public company management and the auditor of record regarding financial reporting issues. Researchers have raised concerns that the "red flag" signal may be eliminated by mandatory audit firm rotation, as investors may not be able to distinguish a scheduled change from a nonscheduled change in a public company's auditor of record.

Regarding the "red flag" signal, most Tier 1 firms believed that mandatory audit firm rotation would not change the current reaction by investors to a change in the auditor of record, and therefore a "red flag" signal is likely to be perceived by investors for both scheduled and unscheduled changes in the public company's auditor of record. Several Tier 1 firms commented that users of financial statements would not be able to readily track scheduled rotations and therefore would be confused whether the change in auditors was scheduled or unscheduled. In contrast, most Fortune 1000 public companies believed that scheduled auditor changes under mandatory audit firm rotation would likely not produce a "red flag" signal and that the "red flag" signal for unscheduled changes in the auditor of record would be retained. Fortune 1000 public companies did not provide any comments to further explain their beliefs. However, currently, public companies are required by SEC regulations to report changes in their auditor of record to the SEC. Therefore, public companies could use this reporting requirement to disclose whether the change in auditor of record under mandatory audit firm rotation was scheduled or unscheduled.

Potential Impact on Audit-Related Costs and Fees

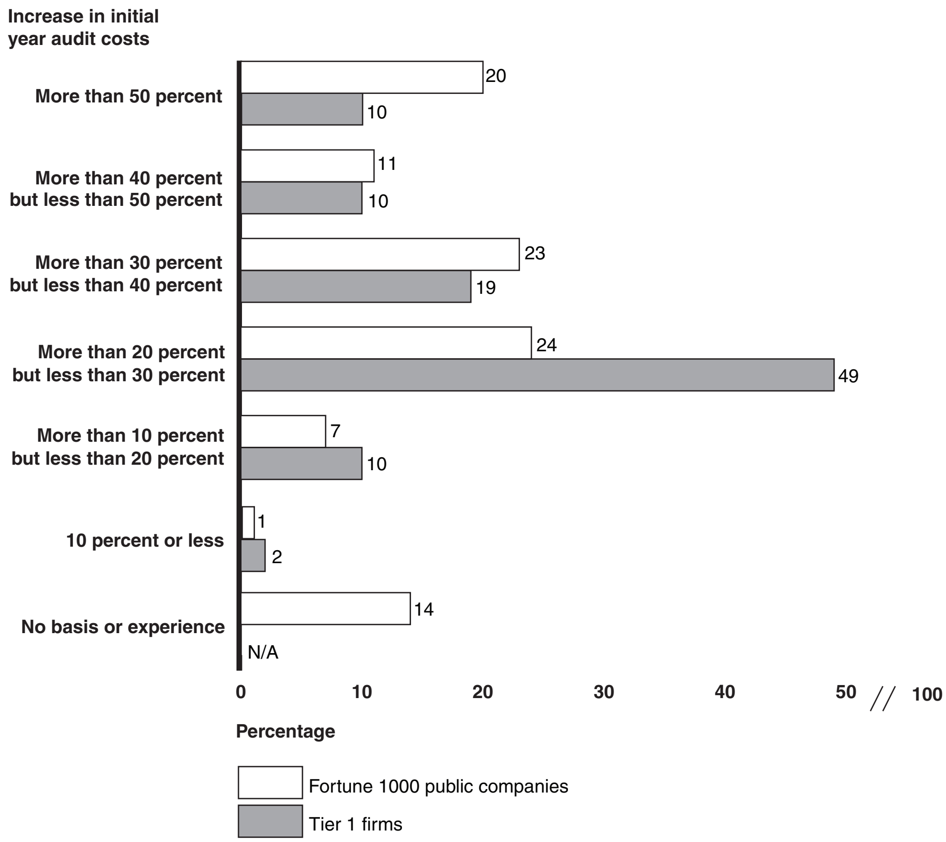
Opponents of mandatory audit firm rotation believe that the more frequent change in auditors likely to occur under mandatory audit firm rotation will result in the public accounting firms and ultimately public companies incurring increased costs for audits of financial statements. These costs include

- marketing costs (the costs incurred by public accounting firms related to their efforts to acquire or retain financial statement audit clients),
- audit costs (the costs incurred by a public accounting firm to perform an audit of a public company's financial statements),
- audit fee (the amount a public accounting firm charges the public company to perform the financial statement audit),
- selection costs (the internal costs incurred by a public company in selecting a new public accounting firm as the public company's auditor of record), and
- support costs (the internal costs incurred by a public company in supporting the public accounting firm's efforts to understand the public company's operations, systems, and financial reporting practices).

About 96 percent of Tier 1 firms stated that their initial year audit costs are likely to be more than in subsequent years in order to acquire the necessary knowledge during a first year audit of a public company's operations, systems, and financial reporting practices. Nearly all of these Tier 1 firms estimated initial year audit costs would be more than 20 percent higher than subsequent years' costs.[29] Similar responses were received from Fortune 1000 public companies. (See fig. 5.)

[29] Several Tier 1 firms commented that mandatory audit firm rotation could also result in costs to relocate staff given the unpredictability of where new audit clients would be located and increased costs for education and training of staff.

Figure 5: Expected Increase in Initial Year Audit Costs over Subsequent Year Audit Costs



Source: GAO analysis of survey data.

About 85 percent of Tier 1 firms stated that currently they are more likely to absorb their higher initial year audit costs than to pass them on to the public companies in the form of higher audit fees because of the firms' interest in retaining the audit client. However, about 87 percent said such costs would likely be passed on to the public companies during the more limited audit firm tenure period under mandatory rotation. Similarly, about 77 percent of Fortune 1000 public companies stated that currently when a change in the companies' auditor of record occurs, the additional initial year audit costs are likely to be absorbed by the public accounting firms. However, about 97 percent of the Fortune 1000 public companies expected the higher initial year audit costs would be passed on to them under mandatory audit firm rotation.

Comments received from a number of the Tier 1 firms indicated that currently initial years' audit costs are recovered from the public companies over the firms' tenure as auditor of record. However, the firms under mandatory audit firm rotation expected not to be able to recover the costs within a more limited tenure as auditor of record. Therefore, they would pass the costs on to the public companies through higher audit fees. Similarly, about 89 percent of Fortune 1000 public companies believed that mandatory audit firm rotation would lead to higher audit fees over time. [30]

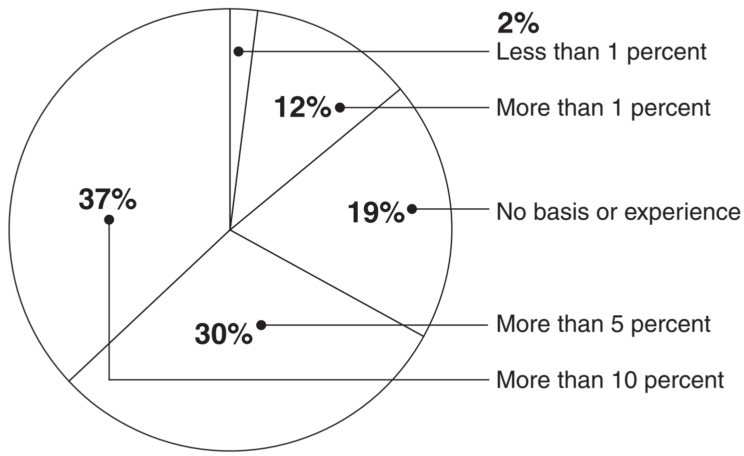
With the likely more frequent opportunities to compete for providing audit services to public companies under mandatory audit firm rotation, about 79 percent of Tier 1 firms expect to incur increased marketing costs associated with their efforts to acquire audit clients, and about 79 percent of the Tier 1 firms expect to pass these costs on to the public companies through higher audit fees.

As shown in figure 6, most of the Tier 1 firms expecting higher marketing costs estimated that the cost would add at least more than 1 percent to their initial year audit fees, and about 37 percent of these Tier 1 firms[31] believed their additional marketing costs would be more than 10 percent of their initial year audit fees.

[30] Many Fortune 1000 public companies commented that mandatory audit firm rotation would lead to higher audit fees as the public accounting firms would want to recoup their additional costs within the limited time as auditor of record that would be established under mandatory audit firm rotation. Also, they stated there would be no incentive for the public accounting firms to absorb the additional costs since mandatory audit firm rotation would preclude long-term business relationships as the auditor of record.

[31] The 95 percent confidence interval for the estimate of these Tier 1 firms that expect more than a 10 percent increase ranges from 29 percent to 45 percent. Also, as shown in figure 6, the 95 percent confidence interval for the estimate of Tier 1 firms who have no basis or experience to estimate what their increase would be ranges from 15 percent to 27 percent.

Figure 6: Tier 1 Firms Expecting Additional Expected Marketing Costs under Mandatory Audit Firm Rotation Compared to Initial Year Audit Fees

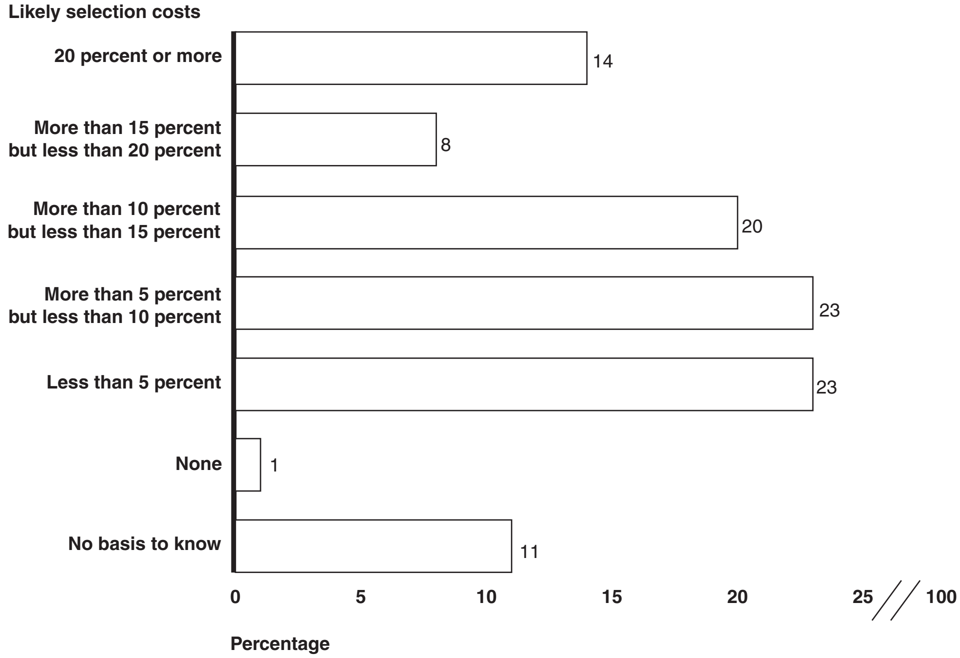


Source: GAO analysis of survey data.

A number of Tier 1 firms commented that they would have to spend more time marketing auditing services, including writing new proposals to compete for audit services. About 85 percent of Fortune 1000 public companies expected that public accounting firms would likely incur additional marketing costs under mandatory audit firm rotation, and about 92 percent of these Fortune 1000 public companies believed the costs would be passed on to them.

In addition to higher audit fees, nearly all Fortune 1000 public companies believed they would incur selection costs in hiring a new auditor of record under mandatory audit firm rotation. As shown in figure 7, most of those Fortune 1000 public companies expected the selection costs to be at least 6 percent or higher as a percentage of initial year audit fees.

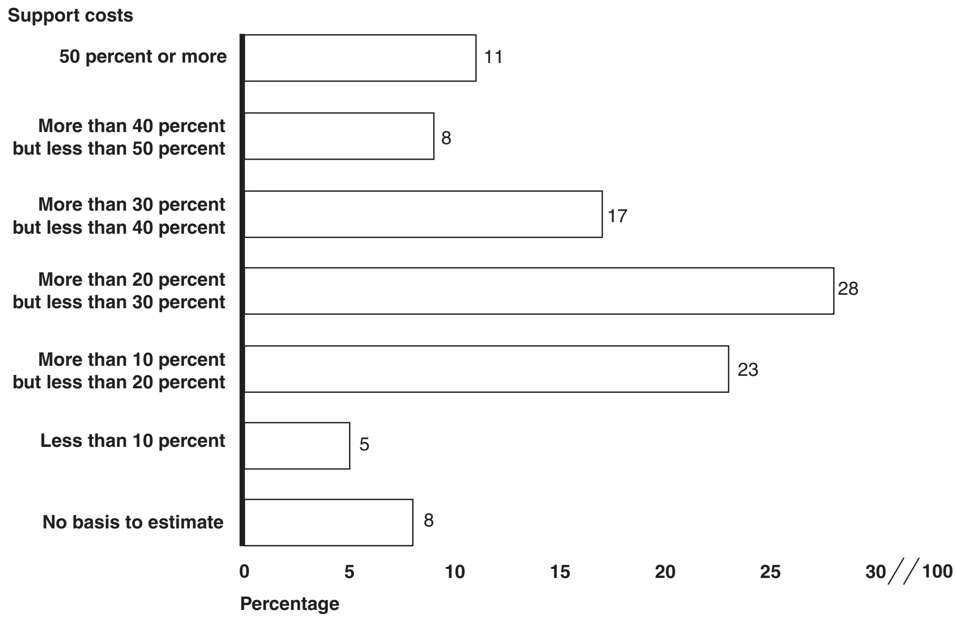
Figure 7: Fortune 1000 Public Companies' Expected Selection Costs as a Percentage of Initial Year Audit Fees



Source: GAO analysis of survey data.

In addition, nearly all Fortune 1000 public companies expected to incur some additional initial year auditor support costs under mandatory audit firm rotation. As shown in figure 8, nearly all of those Fortune 1000 public companies believed their additional support costs would be 11 percent or higher as a percentage of initial year audit fees.

Figure 8: Fortune 1000 Public Companies' Expected Support Costs as a Percentage of Initial Year Audit Fees



Source: GAO analysis of survey data.

Tier 1 firms' views on the likelihood of public companies incurring selection costs and additional auditor support costs were similar to the views of Fortune 1000 public companies.

To provide some perspective on the possible impact of higher audit-related costs (audit fees, company selection, and support cost) on public company operating costs, we analyzed financial reports filed with the SEC for a selection of large and small public companies for the most recent fiscal year available—one of each from 23 broad industry sectors, such as agriculture, manufacturing, and information services. Where available, for each industry sector, we selected a public company with annual revenues of more than $5 billion and a public company with annual revenues of less than $1 billion. The audit fees reported by the larger public companies we selected ranged from .007 percent to .11 percent of total operating costs and averaged .04 percent. The audit fees reported by the smaller public companies we selected ranged from 0.017 percent to 3.0 percent and averaged 0.08 percent.[32]

Utilizing the predominant responses[33] from Tier 1 firms, we estimate the additional first year audit costs following a change in auditor to likely range from 21 percent to 39 percent more than annual costs of recurring audits of the same client. In addition, we estimate the additional firm marketing costs under mandatory audit firm rotation to likely range from 6 percent to 11 percent of the firm's initial year audit fees. Based on the predominant responses from Fortune 1000 public companies, we also estimate the additional public company selection costs to range from 1 percent to 14 percent of the new auditor's initial year audit fees and possible additional public company support costs to range from 11 percent to 39 percent of the new auditor's initial year audit fees. Utilizing these ranges, we estimate that following a change in auditor under mandatory audit firm rotation, the possible additional first year audit-related costs could range from 43 percent to 128 percent higher than the likely recurring audit costs had there been no change in auditor. We also calculated a weighted average percentage for each additional cost category using all responses from Tier 1 firms and Fortune 1000 public companies (as opposed to the predominant responses only). Using the resulting weighted averages for all responses, we calculated the potential additional first year audit-related costs to be 102 percent higher than the likely recurring audit costs had there been no change in auditor. This illustration is intended only to provide insights into how Tier 1 firms and Fortune 1000 public companies reported that mandatory audit firm rotation could affect the initial year audit costs and is not intended to be representative.

Competition-Related Issues

Although mandatory audit firm rotation is generally considered by its proponents as a means of enhancing auditor independence and audit quality, mandatory rotation may also provide increased opportunities for

[32] The public company annual reports for the most recent fiscal year available (either 2002 or 2003) did not disclose any auditor selection or support costs that the companies may have incurred.

[33] We established the various ranges used for this analysis based on our analysis of the responses from Tier 1 firms and Fortune 1000 public companies. In establishing the ranges, we used survey responses consisting of the predominant responses (at least 68 percent) of those received.

some public accounting firms to compete to provide audit services to public companies. About 52 percent of Tier 1 firms believed that mandatory audit firm rotation would increase the opportunity to compete for public company audits and 30 percent were uncertain whether opportunities to compete to provide audit services would increase or decrease.

However, when asked how mandatory audit firm rotation would likely affect the number of firms actually willing and able to compete for public company audits, about 54 percent of Tier 1 firms said mandatory rotation would likely decrease the number of firms competing for audits of public companies, 14 percent expected an increase in the number of firms, and 22 percent expected no effect on the number of firms competing.

Although nearly all Tier 1 firms planned to register with the PCAOB to provide audit services to public companies,[34] about 24 percent of Tier 1 firms that currently provide audit services were uncertain whether they would continue to provide audit services to public companies if mandatory audit firm rotation were required.[35] Firms in Tier 2 that responded to our survey showed more uncertainty regarding whether to register with the PCAOB, with about two-thirds planning to continue to provide audit services to public companies and most of the remaining respondents uncertain if they would continue to provide audit services to public companies.[36] However, if mandatory audit firm rotation were required, 55 percent of the Tier 2 firms that responded to our survey that currently provide audit services to public companies were uncertain whether they would continue to provide the audit services to public companies, and another 12 percent said they would discontinue providing audit services to public companies.[37]

[34] As of October 22, 2003, 89 percent of those Tier 1 firms that responded to our survey have registered with the PCAOB or have applications pending.

[35] In total, these Tier 1 firms that were uncertain whether they would continue to provide audit services to public companies if mandatory audit firm rotation were required audit 586 public companies.

[36] As of October 22, 2003, 80 percent of these Tier 2 firms that responded to our survey have registered with the PCAOB or have applications pending.

[37] In total, these Tier 2 firms that would discontinue providing audit services to public companies if mandatory audit firm rotation were required audit 154 public companies.

The view of many Tier 1 firms that mandatory audit firm rotation may lead to fewer firms willing and able to compete for public company audits, which would lead to higher audit fees, should also be considered along with the results of our study of consolidation of the Big 8 firms into the current Big 4 firms.[38] In that respect, we previously reported that the Big 4 audit over 78 percent of all U.S. public companies and 99 percent of public company annual sales. However, we found no empirical evidence of impaired competition. Further, we previously reported that smaller public accounting firms were unable to successfully compete for the audits of large national and multinational public companies because of factors such as lack of capacity and capital limitations.[39]

About 83 percent of Tier 1 firms and 66 percent of Fortune 1000 public companies stated that under mandatory audit firm rotation, the market share of public company audits would either become more concentrated in a small number of larger public accounting firms or the already highly concentrated market share would remain about the same. About 44 percent of Tier 1 firms believed that incentives to create or maintain large firms would be increased while 32 percent believed mandatory audit firm rotation would have no effect on incentives to create or maintain large firms.

About 52 percent of Fortune 1000 public companies were at least somewhat concerned that the dissolution of Arthur Andersen LLP, resulting now in the Big 4 public accounting firms, would significantly limit the options their companies have in selecting a capable auditor of record. Under mandatory audit firm rotation, the number of Fortune 1000 public companies expressing such concern increased to 79 percent.

About 48 percent of Tier 1 firms believed mandatory audit firm rotation would decrease the number of firms willing and able to compete for audits of public companies in specialized industries, while 29 percent of Tier 1 firms believed mandatory audit firm rotation would have no effect. As noted in our July 2003 report, we found that in certain specialized industries, the number of firms with expertise in auditing those industries

[38] GAO-03-864.

[39] A number of Tier 1 firms responding to our survey on mandatory audit firm rotation commented that the increased costs likely to be incurred by the firms under mandatory audit firm rotation could result in many smaller firms being unable to compete or absorb the increased costs, resulting in smaller firms leaving the market for providing audit services.

can limit the number of choices such public companies have to two public accounting firms. Contributing to this situation is that many public companies will use only Big 4 firms for audit services. Also, public companies may have fewer choices in the future as auditor independence rules under the Sarbanes-Oxley Act prohibiting the auditor of record from also providing certain nonaudit services could further reduce the number of eligible auditors. In that respect, mandatory audit firm rotation would further affect the number of eligible auditors. For example, if a public company in a specialized industry has only three or four choices for its auditor of record, the current auditor of record is not eligible to repeat as auditor of record under mandatory audit firm rotation, and another firm is not eligible because it provided prohibited nonaudit services that affect auditor independence to the public company, then the number of eligible firms would be reduced to one or two firms.

About 35 percent of Fortune 1000 public companies were at least somewhat concerned that the Sarbanes-Oxley Act auditor independence requirements would significantly limit their options in selecting a capable auditor of record. However, 53 percent of Fortune 1000 public companies expressed such concern if mandatory audit firm rotation were required.

The Sarbanes-Oxley Act requires the audit committee to hire, compensate, and oversee the public accounting firm serving as auditor of record for the public company. About 92 percent of the Fortune 1000 audit committee chairs stated that their public companies currently use Big 4 firms as auditor of record, and 94 percent of those that do stated that they would not realistically consider using non-Big 4 firms as the public companies' auditor of record. Table 1 provides reasons given by the audit committee chairs for only using Big 4 firms and the importance of those reasons to them.

Table 1: Audit Committee Chairs' Reasons for Limiting Consideration to Only Big 4 Firms

Numbers in percentages

Reasons for limiting consideration to only Big 4 firms	Very great importance	Great importance	Moderate importance	Some importance	Little or no importance	Don't know
Expectations of the capital markets	48	34	14	1	3	0
Public company geographic/global operations	53	27	10	4	6	0
Public company operations require specialized industry skills/knowledge	39	36	18	6	1	0
Public company contractual obligations (e.g. with banks or lenders)	15	28	25	5	20	7
Requirement of the public company's board of directors	23	35	19	7	13	3
Sufficiency of audit firm resources	68	26	4	2	0	0
Audit firm's name and reputation	35	41	18	4	2	0

Source: GAO analysis of survey data.

Although the Sarbanes-Oxley Act now makes the audit committee responsible for hiring the public company's auditor of record, 96 percent of Fortune 1000 public companies currently using Big 4 firms also stated that they would not realistically consider using non-Big 4 firms as the companies' auditor of record. They generally gave the same reasons as the audit committee chairs.

Overall Views on Mandatory Audit Firm Rotation

In our surveys, we asked public accounting firms, public companies, and their audit committee chairs to provide their overall views on the potential costs and benefits that may result under mandatory audit firm rotation. About 85 percent of Tier 1 firms, 92 percent of Fortune 1000 public companies, and 89 percent of Fortune 1000 audit committee chairs believed that costs are likely to exceed benefits.

Our surveys also requested views whether the Sarbanes-Oxley Act auditor independence and related audit quality requirements could also achieve the intended benefits of mandatory audit firm rotation. The act, as implemented by SEC rules, requires the mandatory rotation of both lead and reviewing audit engagement partners after 5 years and after 7 years for other partners with significant involvement in the audit engagement. Other related provisions of the act concerning auditor independence and audit quality include prohibiting the auditor of record from also providing certain nonaudit services, requiring audit committee preapproval of audit and nonaudit services not otherwise prohibited and related public disclosures, establishing certain auditor reporting requirements to the audit committee, requiring time restrictions before certain auditors could be hired by the client as employees, expanding audit committee responsibilities, and establishing the PCAOB as an independent nongovernmental entity overseeing registered public accounting firms in the audit of public companies.

About 66 percent of Tier 1 firms believe the audit partner rotation requirements sufficiently achieve the intended benefits of a "fresh look" of mandatory audit firm rotation. Another 27 percent of the Tier 1 firms believe that the audit partner rotation requirements may not be as effective as mandatory audit firm rotation in achieving the intended benefits of a "fresh look," but is a better choice given the higher cost of mandatory audit firm rotation. Fortune 1000 public companies and audit committee chairs responding to our survey expressed similar views.

We asked those Tier 1 firms and Fortune 1000 public companies and their audit committee chairs who did not believe that the partner rotation requirement by itself sufficiently achieved the intended benefits of mandatory audit firm rotation to consider the auditor independence, audit quality, and partner rotation requirements of the Sarbanes-Oxley Act as implemented by SEC rules and their views on whether these requirements in total would likely achieve the intended benefits of mandatory audit firm rotation when fully implemented. About 25 percent[40] of these Tier 1 firms believed these requirements of the Sarbanes-Oxley Act, when fully implemented, would sufficiently achieve the intended benefits of mandatory audit firm rotation, while 63 percent[41] believed these requirements would only somewhat or minimally achieve the intended benefits of mandatory audit firm rotation when fully implemented. Conversely, 76 percent[42] of Fortune 1000 public companies and 72 percent[43]

[40] The 95 percent confidence interval surrounding this estimate ranges from 17 percent to 39 percent.

[41] The 95 percent confidence interval surrounding this estimate ranges from 48 percent to 72 percent.

[42] The 95 percent confidence interval surrounding this estimate ranges from 62 percent to 86 percent.

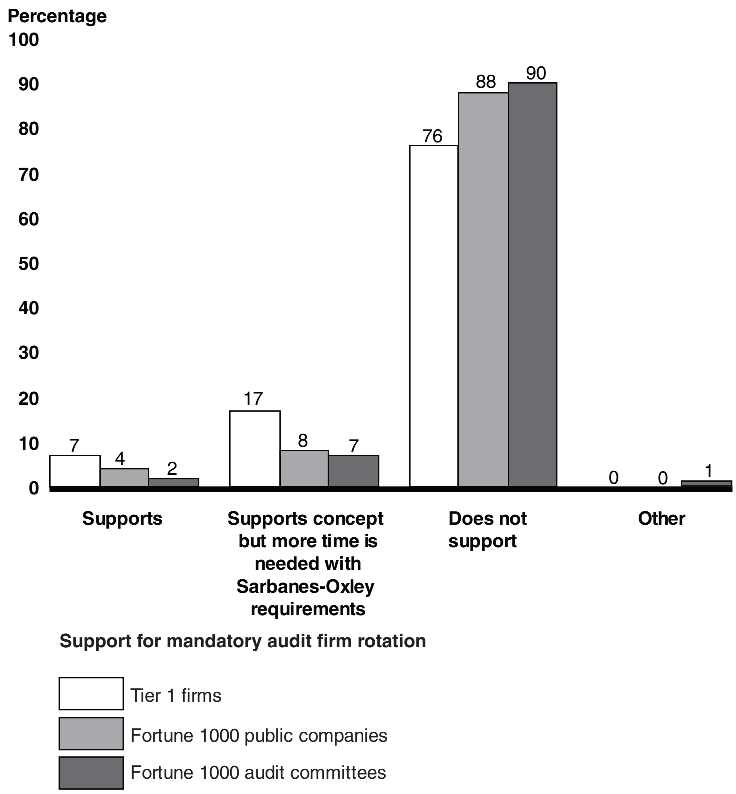
[43] The 95 percent confidence interval surrounding this estimate ranges from 58 percent to 84 percent.

of their audit committee chairs believed these requirements would sufficiently achieve the intended benefits of mandatory audit firm rotation. Combining the responses to the above two questions for those who believed either the partner rotation requirements or the partner rotation requirements coupled with the other Sarbanes-Oxley Act auditor independence and audit quality requirements would sufficiently achieve the benefits of mandatory audit firm rotation shows that about 75 percent of the Tier 1 firms, 95 percent of Fortune 1000 public companies, and about 92 percent of the audit committee chairs believe these requirements, when fully implemented, would sufficiently achieve the benefits of mandatory audit firm rotation.

Most Tier 1 firms and Fortune 1000 public companies and their audit committee chairs believe the Sarbanes-Oxley Act auditor independence and audit quality requirements, when fully implemented, would sufficiently achieve the benefits of mandatory audit firm rotation, and most of these groups when asked their overall opinion on mandatory audit firm rotation did not support mandatory rotation.[44] A minority within these groups supports the concept of mandatory audit firm rotation, but believes more time is needed to evaluate the effectiveness of the various Sarbanes-Oxley Act requirements for enhancing auditor independence and audit quality. (See fig. 9.)

[44] Comments from a number of the Tier 1 firms primarily reiterated their previously stated views regarding the costs and benefits of mandatory audit firm rotation and that the SEC's recent audit partner rotation requirements better balance the need for a "fresh look" without eliminating the auditor of record's institutional knowledge of the client. They also reiterated that the Sarbanes-Oxley Act should be given time to work and rebuild investors' confidence. Similar comments were received from many of the Fortune 1000 public companies' chief financial officers and their audit committee chairs who also stressed the additional costs of mandatory audit firm rotation.

Figure 9: Support for Mandatory Audit Firm Rotation



Source: GAO analysis of survey data.

Overall Views of Other Knowledgeable Individuals on Mandatory Audit Firm Rotation

As part of our review, we spoke to a number of knowledgeable individuals to obtain their views on mandatory audit firm rotation to provide additional perspective on issues addressed in the survey. These individuals had experience in a variety of fields, such as institutional investment; regulation of the stock markets, the banking industry, and the accounting profession; and consumer advocacy. Generally, the views expressed by these knowledgeable individuals were consistent with the overall views expressed by survey respondents.[45] Most did not favor implementing a requirement for mandatory audit firm rotation at this time because they

[45] SEC and PCAOB officials informed us that they have not taken a position on the merits of mandatory audit firm rotation.

believe the costs of implementing such a requirement outweigh the benefits and greater experience with implementing the requirements of the Sarbanes-Oxley Act should be gained prior to adding new requirements.

Many individuals acknowledged that conceptually, audit firm rotation could provide certain benefits in the areas of auditor independence and audit quality. For example, audit firm rotation may increase the perception of auditor independence because long-term relationships between the auditor of record and the client that could undermine independence would not likely develop under the limited term as auditor of record. Some individuals also believe that under mandatory audit firm rotation, the auditor might be less likely to succumb to management pressure to accept questionable accounting practices because the incentive to keep the client is gone and another audit firm would be looking at the firm's work in the future. Some also believed that audit quality may also be increased through a change in auditors because a new auditor of record would provide a "fresh look" at an entity's financial reporting practices and accounting policies. In addition, some individuals noted that mandatory audit firm rotation might cause a company to reexamine its audit needs and seek more knowledgeable and experienced audit firm personnel when negotiating for a new auditor of record.

The individuals we spoke to, however, acknowledged a number of practical concerns related to mandatory audit firm rotation, one of the most important being the limited number of audit firms available from which to choose. For example, some companies, especially those with geographically diverse operations or those operating in certain industries, may be somewhat limited in the choice of auditing firms capable of performing the audit. Not all audit firms have offices or staff located in all the geographic areas, whether domestically or internationally, where the clients conduct their operations, nor do all audit firms have personnel with certain industry knowledge to be able to perform audits of clients that operate in specific environments.

Similar to the views of Fortune 1000 public companies and audit committee chairs, individuals we spoke to noted that large companies are often limited to choices among the Big 4 firms. In some cases, the choices are further restricted because the accounting profession has become segmented by industry, and a lack of industry-specific knowledge may preclude some firms from performing the audits. For a company that is limited to use of Big 4 firms, it was viewed that selection may also be restricted because an audit firm providing certain nonaudit services or serving as a company's internal auditor is prohibited by independence rules from also serving as that company's auditor of record. In some cases, a company may also be limited in its choice of firms if an audit firm audits one of the company's major competitors and the public company decides not to use that firm as its auditor of record.

With regard to the use of a Big 4 firm, some individuals believe that although a new auditor provides a "fresh look" at an audit engagement, the Big 4 audit firms have somewhat similar cultures and methodologies for performing audits, and as a result, the benefit of a "fresh look" is more limited today than it was in the past when the firms had different cultures and employed a greater variety of methodologies.

Many individuals we spoke with also noted that when a change in auditor of record occurs, a learning curve, which can last a year or more, exists while the new auditor becomes familiar with the client's operations, thus increasing the audit risk associated with the engagement. Although a new auditor provides a "fresh look" for the audit, concern was raised that a new auditor may challenge the previous auditor's judgments in an overly aggressive manner because the new auditor is not familiar with the client's operations or accounting policies, and this poses a problem for the public company because the previous auditor is not present to explain the rationale for those judgments. It was viewed that in some cases, these are matters of professional judgment rather than actual errors and that such a situation could result in increased tension between the client and new auditor of record.

Some individuals we spoke with expressed concern that if mandatory audit firm rotation were implemented, the audit firm may rotate its most qualified staff off the engagement during the later years of audit tenure because the audit firm might focus its resources on obtaining or providing services to new clients. These individuals believe that such a practice would increase audit risk, as did most Tier 1 firms and Fortune 1000 public companies. Some individuals also expressed concern that toward the end of audit tenure, an audit firm might shift its attention to marketing nonaudit services the firm could provide when it was no longer the auditor of record, which may be counter to the intended benefits of mandatory audit firm rotation.

Individuals we spoke with also noted other implementation issues with mandatory audit firm rotation. For example, they viewed mandatory audit firm rotation as increasing costs to a company, not only in terms of higher audit fees but also in additional selection and support costs. In particular, many individuals we spoke with, as did most Tier 1 firms and Fortune 1000 public companies, believed that when a company rotates auditors, a certain amount of disruption occurs and the company spends a significant amount of resources—both financial and human—educating the new auditor about company operations and accounting matters. Individuals we spoke with expressed concern not only that these additional audit, selection, and support costs are ultimately passed on to shareholders but also that audit committees may lose control of selecting the best auditors to provide the best quality to shareholders since the incumbent firm would not be eligible to compete to provide audit services for some period of time.

Some individuals we spoke with noted that they have already observed a heightened sense of corporate responsibility and better corporate governance as a result of a change in behavior brought about by the large corporate failures in recent years. Overall, the majority of knowledgeable individuals we spoke with believe that a requirement for mandatory audit firm rotation should not be implemented at this time.[46] However, some individuals suggested that regulators could require a change in the auditor of record as an enforcement action if conditions warrant such a measure. Most individuals we spoke with believe that the cost of requiring mandatory audit firm rotation would exceed the benefits because of the various practical concerns noted. Rather, these individuals believe that greater experience with the existing provisions of the Sarbanes-Oxley Act should be gained and the results assessed before the need for the mandatory audit firm rotation is considered. Many individuals we spoke with believe that individual Sarbanes-Oxley Act provisions, such as audit firm partner rotation and the increased responsibilities of the audit committee, are not a substitute for mandatory audit firm rotation, but taken collectively, they could accomplish many of the same intended benefits of mandatory audit firm rotation to improve auditor independence and audit quality. For example, some individuals believe that the existing Sarbanes-Oxley Act provisions related to audit committees have already resulted in more time spent on audit committee activities and greater contact and frequency of meetings with auditors. These individuals commented that audit committees now ask more questions of auditors because of a

[46] Individuals we spoke with that generally supported mandatory audit firm rotation included representatives of entities that currently have mandatory audit firm rotation policies, a consumer advocacy group, two individuals associated with oversight of the accounting profession, an individual knowledgeable in the regulation of public companies, and an expert in corporate governance.

heightened sense of accountability for the performance, accuracy, reliability, and integrity of everything the independent auditors are doing.

Survey Groups Views on Implementing Mandatory Audit Firm Rotation if Required and Other Alternatives for Enhancing Audit Quality

If mandatory audit firm rotation were required a number of implementing factors affecting the structure of the requirement would need to be decided by policy makers (e.g., the Congress and regulators). The following provides the views of Tier 1 firms, Fortune 1000 public companies, and their audit committee chairs on certain implementing factors, regardless of whether they supported mandatory audit firm rotation.

- Most believed that the auditor of record's tenure should be limited to either 5 to 7 years or 8 to 10 years.
- Nearly all believed that when the incumbent auditor of record is replaced, the public accounting firm should not be permitted to compete for audit services for either 3 or 4 years or 5 to 7 years.
- Nearly all believed that the audit committee should be permitted to terminate the business relationship with the auditor of record at any time if it is dissatisfied with the firm's performance. Likewise, most believed that the public accounting firm should be able to terminate its relationship with the audit committee/public company at any time if it is dissatisfied with the working relationship.
- Nearly all believed that implementation of mandatory audit firm rotation should be staggered on a reasonable basis to avoid a significant number of public companies changing auditors simultaneously.
- Most Tier 1 firms believed that mandatory audit firm rotation should not be applied uniformly to all public companies regardless of their nature or size. In contrast, most Fortune 1000 public companies and their audit committee chairs believed mandatory audit firm rotation should be applied to all public companies regardless of nature or size. However, most other domestic and mutual fund companies that responded to our survey believed mandatory audit firm rotation should not be applied uniformly, and their audit committee chairs who responded to our survey were split on the subject.
- The Tier 1 firms and Fortune 1000 audit committee chairs who believed that mandatory audit firm rotation should not be applied uniformly more frequently selected the larger public companies rather than the

smaller public companies to be subject to mandatory audit firm rotation. However, Fortune 1000 public companies were divided on their selection of sizes of public companies that should be subject to mandatory audit firm rotation.

See appendix II for additional details of the responses.

Our research of studies, other documents, and survey development activities concerning issues related to mandatory audit firm rotation identified the following other practices for potentially enhancing auditor independence and audit quality:

- the audit committee periodically holding an open competition for providing audit services,
- requiring audit managers to periodically rotate off the engagement for providing audit services to the public company,
- the audit committee periodically obtaining the services of a public accounting firm to assist it in overseeing the financial statement audit or to conduct a forensic audit in areas of the public company's financial statement process that present a risk of fraudulent financial reporting, and
- the audit committee hiring the auditor of record on a noncancelable multiyear basis in which only the public accounting firm could terminate the business relationship for cause during the contract period.

Although many Tier 1 firms, Fortune 1000 public companies, and their audit committee chairs saw some benefit in each of the alternative practices, in general, they most frequently reported that the alternative practices would have limited or little benefit. The most notable exception involved the practice in which an audit committee would hire an auditor of record on a noncancelable multiyear basis, for which most Fortune 1000 public companies and their audit committee chairs reported that the practice would have no benefit. (See table 5 in app. III.)

Regarding practices other than mandatory audit firm rotation that may have potential value to enhance auditor independence and audit quality, the Sarbanes-Oxley Act provides the PCAOB with the authority to set auditing and related attestation, ethics, independence, and quality control standards for registered public accounting firms and for conducting inspections to determine compliance of each registered public accounting firm with the rules of the PCAOB, the SEC, or professional standards in connection with the performance of audits, the issuance of audit reports, and related matters involving public companies. In that respect, the PCAOB's inspection program for registered public accounting firms could also provide the PCAOB with the opportunity to provide a "fresh look" at the auditor of record's performance regarding auditor independence and audit quality. For example, the inspections could include factors potentially affecting auditor independence, such as length of the auditor's tenure, partners or managers of the audit firm who recently left the firm and are now employed by the public company in financial reporting roles, and nonaudit services provided by the auditor of record, as suggested by the Conference Board Commission on Public Trust and Private Enterprise in its January 9, 2003, report. Also, the inspections could consider the auditor's work in high-risk areas of the public company's operations and related financial reporting. Further, the inspections can serve to provide some degree of transparency of their overall results and enforcement of PCAOB and SEC requirements that may be useful for audit committees to consider.

Auditor Experience in Restatements of annual Financial Statements Filed with the SEC for 2001 and 2002

With the dissolution of Arthur Andersen LLP in 2002, Tier 1 firms reported replacing Anderson, as auditor of record, for more than 1,200 public company clients since December 31, 2001. Such volume of change in auditors provided an unprecedented opportunity to gain some actual experience with the potential value of the "fresh look" provided by a new auditor. Since many of these public companies had to replace Andersen as their auditor of record during 2002, the number of changes in their auditor of record effectively represented a partial form of mandatory audit firm rotation. We identified all annual restatements of financial statements filed on a Form 10-KA and any annual restatements included in an annual Form 10K filing with the SEC by Fortune 1000 public companies for 2001 and 2002 through August 31, 2003, and focused on which restatements were attributable to errors or fraud where the previous financial statements did not comply with GAAP and identified whether there was a change in the auditor of record.

We found that 28, or 2.9 percent, of the 960 Fortune 1000 public companies changed their auditor of record during 2001, and 204, or 21.3 percent, of the companies changed their auditor during 2002. The significant increase from 2001 through 2002 was primarily due to the dissolution of Andersen. Our analysis showed that the Fortune 1000 public companies filed 43 restatements during those 2 years that were due to errors or fraud. The financial statements affected ranged from years 1997 to 2002. The misstatement rates of these public companies' previously issued statements of net income ranged from a 6.7 percent overstatement of net income for 2000 to a 37.0 percent understatement of net loss for 2001.

The restatement rates due to errors or fraud among the 43 Fortune 1000 public companies that changed their auditor of record were 10.7 percent in 2001 and 3.9 percent in 2002 compared to restatement rates of 2.5 percent in 2001 and 1.2 percent in 2002 for companies that did not change auditors. Although the data indicate that the overall restatement rate is approximately 4.5 times higher for 2001 and 3.25 times higher for 2002 for the companies that changed their auditor of record as compared to those companies that did not change auditors, caution should be taken as further analysis would be needed to determine whether the restatements are associated with the "fresh look" attributed to mandatory audit firm rotation. In that respect, for the majority of the restatements, the public information filed with the SEC and included in the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system did not provide sufficient information to determine whether company management, the auditor of record, or regulators identified the error or fraud, and in those cases in which there was a change in the auditor of record, whether the predecessor auditor or the successor auditor identified the problem and whether it was identified before or after the change in auditor of record. Also, the recent corporate financial reporting failures have greatly increased the pressures on company management and their auditors regarding honest, fair, and complete financial reporting. See appendix IV for additional details of our analysis.

Regarding further analysis to determine whether restatements are associated with the "fresh look," we believe such additional future research could potentially add value to better predict the benefits of mandatory audit firm rotation and the future need for mandatory audit firm rotation. See the observations section of this report for our views on mandatory audit firm rotation considering the Sarbanes-Oxley Act's requirements for enhancing auditor independence and audit quality and other factors to consider in evaluating the need for mandatory audit firm rotation.

Experience of Foreign Countries with Mandatory Audit Firm Rotation

To obtain other countries' current or previous experience with or consideration of mandatory audit firm rotation, we surveyed the securities regulators of the Group of Seven Industrialized Nations (G-7), which included the United Kingdom, Germany, France, Japan, Canada, and Italy. In addition to the G-7 countries' securities regulators, we also surveyed the following members of the International Organization of Securities Commissions (IOSCO)[47]: Australia, Austria, Belgium, Brazil, China, Hong Kong, Luxembourg, Mexico, the Netherlands, Singapore, Spain, Sweden, and Switzerland.[48] The IOSCO members represent these foreign countries' organizations with duties and responsibilities which are similar to the SEC in the United States. We received responses from 11 of the 19 countries' securities regulators surveyed.

Italy and Brazil reported having mandatory audit firm rotation for public companies, and Singapore reported the requirement for banks that are incorporated in Singapore. Austria also reported that beginning in 2004, mandatory audit firm rotation will be required for the auditor of record of public companies. Spain and Canada reported that they previously had mandatory audit firm rotation requirements. Generally, reasons reported for requiring mandatory audit firm rotation related to auditor independence, audit quality, or increased competition for providing audit services. Reasons for abandoning the requirements for mandatory audit firm rotation related to its lack of cost-effectiveness, cost, and having achieved the objective of increased competition for audit services. Many of the survey respondents also reported either requiring or considering audit partner rotation requirements that are similar to the requirements of the Sarbanes-Oxley Act. See appendix V for additional information on the survey respondents' experiences and consideration of mandatory audit firm rotation and audit partner rotation.

[47] IOSCO is an international association of securities regulators that was created in 1983 to promote high standards of regulation in order to maintain just, efficient, and sound markets, promote the development of domestic markets, establish standards and an effective surveillance of international securities transactions, and promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offenses.

[48] Based on our review of literature concerning mandatory audit firm rotation, we found that Saudi Arabia was identified as presently requiring mandatory audit firm rotation of public companies. While Saudi Arabia is not an IOSCO member, we attempted to administer our survey to the Saudi Arabian Monetary Authority, Saudi Arabia's financial supervisory authority, but did not receive a response.

GAO Observations

The Sarbanes-Oxley Act contains significant reforms intended to enhance auditor independence and audit quality, which are viewed by the groups of stakeholders we surveyed or held discussions with as likely to sufficiently achieve the same intended benefits as mandatory audit firm rotation when fully implemented. In that respect, the SEC's regulations to implement the auditor independence and audit quality requirements of the act have only recently been issued, and the PCAOB is in the process of implementing its inspection program. Therefore, we believe it will take at least several years to gain some experience with the effectiveness of the act's requirements concerning auditor independence and audit quality.

We believe that it is critical for both the SEC and the PCAOB, through its oversight and enforcement programs, to formally monitor the effectiveness of the regulations and programs intended to implement the Sarbanes-Oxley Act. This information will be valuable in considering whether changes, including mandatory audit firm rotation, may be needed to further protect the public interest. We noted that survey responses from Tier 1 firms show that the potential for lawsuits or regulatory action is a major incentive for the firms to appropriately deal with public company management in resolving financial reporting issues. We believe that the SEC's and PCAOB's rigorous enforcement of regulations and other requirements will be critical to the effectiveness of the act's requirements.

It is clear that the likely additional costs associated with mandatory rotation have influenced the views of Tier 1 firms and Fortune 1000 public companies and their audit committee chairs to not support mandatory rotation. However, we believe that these additional costs need to be balanced with the need to protect the public interest, especially considering the recent significant accountability breakdowns and their impact on investors and other interested parties. Although expecting to have zero financial reporting/audit failures is not a realistic expectation, Enron, WorldCom, and others have recently demonstrated that a single financial reporting/audit failure of a major public company can have significant consequences to shareholders and other interested parties. We believe it is fairly certain that mandatory audit firm rotation would result in selection costs and additional support costs for public companies. Also, most Tier 1 firms and Fortune 1000 public companies believe that mandatory audit firm rotation would also result in higher audit fees, primarily due to higher initial years' audit costs.

If public accounting firms under mandatory audit firm rotation have (1) a shorter tenure as auditor of record to recover higher initial year audit costs and (2) fewer opportunities to also sell nonaudit services due to the Sarbanes-Oxley Act requirements concerning prohibited nonaudit services, then we believe it is reasonable to assume, as public accounting firms and public companies have done, that the higher initial year audit costs associated with a new auditor are likely to be passed on to the public companies, along with increased marketing costs. However, competition among public accounting firms for providing audit services should to some extent also affect audit fees. Therefore, we believe it is uncertain at this time how these dynamics would play out in the market for audit services and their effect on audit fees over the long term. However, if intensive price competition were to occur, the expected benefits of mandatory audit firm rotation could be adversely affected if audit quality suffers due to audit fees that do not support an appropriate level of audit work.

We believe that mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality, considering the costs of changing the auditor of record and the loss of auditor knowledge that is not carried forward to the new auditor. We also believe that the potential benefits of mandatory audit firm rotation are harder to predict and quantify while we are fairly certain there will be additional costs. In that respect, mandatory audit firm rotation is not a panacea that totally removes pressures on the auditor in appropriately resolving financial reporting issues that may materially affect the public companies' financial statements. Those pressures are likely to continue even if the term of the auditor is limited under any mandatory rotation process. Furthermore, most public companies will only use the Big 4 firms for their auditor of record for a variety of reasons, including the firms' having sufficient industry knowledge and resources to audit their companies and expectations of the capital markets to use Big 4 firms. These public companies may only have 1 or 2 choices for their auditor of record under any mandatory rotation system. However, over time a mandatory audit firm rotation requirement may result in more firms transitioning into additional industry sectors if the market for such audits has sufficient profit margins.

The current environment has greatly increased the pressures from regulators and investors on public company management and public accounting firms to have financial statements issued by public companies that comply with GAAP and provide full disclosure. These pressures and the reforms of the Sarbanes-Oxley Act provide incentives to have financial reporting that is honest, fair, and complete and that serves the public interest. If such reporting is widely and consistently achieved then the likelihood of the "fresh look" serving to identify financial reporting issues that may materially affect financial statements that were either overlooked or not appropriately dealt with by the previous auditor of record will be reduced. However, it is uncertain at this time if the current climate and pressures for accurate and complete financial reporting and for restoring public trust will be sustained over the long term.

Regarding the need for mandatory audit firm rotation, we believe the most prudent course at this time is for the SEC and the PCAOB to monitor and evaluate the effectiveness of the Sarbanes-Oxley Act's requirements for enhancing auditor independence and audit quality, and ultimately restoring investor confidence. In that respect, the PCAOB's inspection program for registered public accounting firms could also provide an opportunity to provide a "fresh look," which would enhance auditor independence and audit quality through the program's inspection activities, and may provide new insights regarding (1) public companies' financial reporting practices that pose a high risk of issuing materially misstated financial statements for the audit committees to consider and (2) possibly either using the auditor of record or another firm to assist in reviewing these areas. In addition, future research on the potential benefits of mandatory audit firm rotation as suggested by our analysis of restatements of financial statements may also be valuable to consider along with the evaluations of the effectiveness of the Sarbanes-Oxley Act.

Further, we also believe that currently audit committees, with their increased responsibilities under the Sarbanes-Oxley Act, can play a very important role in enhancing auditor independence and audit quality. In that respect, the Conference Board Commission on Public Trust and Private Enterprise in its January 9, 2003, report stated that auditor rotation is a useful tool for building shareholder confidence in the integrity of the audit and of the company's financial statements. The commission advocated that audit committees consider rotating audit firms when there are circumstances that could call into question the audit firm's independence from management. The circumstances that merited consideration included when (1) significant nonaudit services are provided to the company by the auditor of record (even if they have been approved by the audit committee), (2) one or more former partners or managers of the audit firm are employed by the company, or (3) lengthy tenure of the auditor of record, such as over 10 years—which our survey results show is prevalent at many Fortune 1000 public companies. In such cases, we believe audit committees need to be especially vigilant in the oversight of the auditor and in considering whether a "fresh look" is warranted. We also believe that if audit committees regularly evaluate whether audit firm rotation would be beneficial, given the facts and circumstances of their companies' situation, and are actively involved in helping to ensure audit independence and audit quality, many of the intended benefits of audit firm rotation could be realized at the initiative of the audit committee rather than through a mandatory requirement.

However, audit committees need to have access to adequate resources, including their own budgets, to be able to operate with the independence necessary to effectively perform their responsibilities under the Sarbanes-Oxley Act. Further, we believe that an audit committee's ability to operate independently is directly related to the independence of the public company's board of directors. It is not realistic to believe that audit committees will unilaterally resolve financial reporting issues that materially affect a public company's financial statements without vetting those issues with the board of directors. Also, the ability of the board of directors to operate independently may also be affected in corporate governance structures where the public company's chief executive officer also serves as the chair of the board of directors. Like audit committees, boards of directors also need to be independent and to have adequate resources and access to independent attorneys and other advisors when they believe it is appropriate. Finally, for any system to function effectively, there must be incentives for parties to do the right thing, adequate transparency to provide reasonable assurance that people will do the right thing, and appropriate accountability when people do not do the right thing.

Agency Comments and Our Evaluation

We provided copies of a draft of this report to the SEC, AICPA, and PCAOB for their review. Representatives of the AICPA and the PCAOB provided technical comments, which we have incorporated where applicable. Representatives of the SEC had no comments.

We are sending copies of this report to the Chairman and Ranking Minority Member of the House Committee on Energy and Commerce. We are also sending copies of this report to the Chairman of the Securities and Exchange Commission, the Chairman of the Public Company Accounting

Oversight Board, and other interested parties. This report will also be available at no charge on GAO's Web site at http://www.gao.gov.

If you or your staffs have any questions concerning this report, please contact me at (202) 512-9471 or John J. Reilly, Jr., Assistant Director, at (202) 512-9517. Key contributors are acknowledged in appendix VI.

Jeanette M. Franzel
Director, Financial Management and Assurance

Objectives, Scope, and Methodology

As mandated by Section 207 of the Sarbanes-Oxley Act of 2002[1] and as agreed with your staff, to perform our study and review of the potential effects of requiring mandatory rotation of registered public accounting firms, we

1. identified and reviewed research studies and related literature that addressed issues concerning auditor independence and audit quality associated with the length of a public accounting firm's tenure and the costs and benefits of mandatory audit firm rotation;

2. analyzed the issues we identified to

- develop detailed questionnaires to obtain the views of public accounting firms and public company chief financial officers and their audit committee chairs on the potential effects of mandatory audit firm rotation,

- hold discussions with officials of other interested stakeholders, such as institutional investors, federal banking regulators, U.S. stock exchanges, state boards of accountancy, the American Institute of Certified Public Accountants (AICPA), the Securities and Exchange Commission (SEC), and the Public Company Accounting Oversight Board (PCAOB), to obtain their views on the issues associated with mandatory audit firm rotation, and

- obtain information from other countries on their experiences with mandatory audit firm rotation; and

3. identified restatements of annual 2001 and 2002 financial statements of Fortune 1000 public companies due to errors or fraud that were reported to the SEC during 2002 and 2003 through August 31, 2003, to

- determine whether the restatement occurred before or after a change in the public companies' auditor of record, and

- test the value of the "fresh look" commonly attributed to mandatory audit firm rotation.

[1] Pub. L. No. 107-204, 116 Stat. 745, 775.

We conducted our work in Washington, D.C., between November 2002 and November 2003 in accordance with U.S. generally accepted government auditing standards.

Identifying Research Studies Concerning Auditor Independence and Audit Quality

To identify existing research related to mandatory audit firm rotation, we utilized several methods including general Internet searches, requests from the AICPA library, the AICPA's Web site (www.aicpa.org), the American Accounting Association's Web site (http://accounting.rutgers.edu/raw/aaa/), the SEC's Web site (www.sec.gov), requests from GAO's internal library resources, and suggestions provided by communities of interest. Also, many studies were identified through bibliographies of previously identified research. We used the following keywords in our searches: "mandatory audit firm rotation," "mandatory auditor rotation," "compulsory audit firm rotation," "compulsory auditor rotation," "auditor rotation," "auditor change(s)," and "auditor switching."

We identified a total of 80 studies, articles, position papers, and reports from our searches. We then applied the following criteria to these studies. We focused on studies that (1) were mostly published no earlier than 1980, (2) contained some original data analyses, and (3) focused on some aspect of mandatory audit firm rotation. Using these criteria, 27 studies were subjected to further methodological review to evaluate the design and approach of the studies, the quality of the data used, and the reasonableness of the studies' conclusions and to determine if any limitations of a study were of sufficient severity to call into question the reasonableness of the conclusion. We eliminated 10 of these studies because they were actually position papers or literature summaries, and did not include any original data analyses. One additional study was eliminated because of fundamental methodological flaws.

Of the remaining 16 studies that were subjected to a high-level methodological review, 7 have major caveats that should be considered along with the results of the studies, while the other 9 have some more minor methodological limitations, such as limited application to the subject; limited data availability; or insufficient information on issues including choice of samples, response rates, and nonresponse analyses. In developing the survey instruments covering issues concerning auditor independence and audit quality associated with the length of a public accounting firm's tenure and the costs and benefits of mandatory audit firm rotation, we primarily used the studies from among this latter group of 9 as listed below.

The Relationship of Audit Failures and Audit Tenure, by Jeffrey Casterella of Colorado State University, W. Robert Knechel of University of Florida and University of Auckland, and Paul Walker of the University of Virginia, November 2002.

Auditor Rotation and Retention Rules: A Theoretical Analysis (Rotation Rules), by Eric C. Weber of Northwestern University, June 1998.

Audit-Firm Tenure and the Quality of Financial Reports, by Van E. Johnson of Georgia State University, Inder K. Khurana of the University of Missouri-Columbia, and J. Kenneth Reynolds of Louisiana State University, Winter 2002.

"The Effects of Auditor Change on Audit Fees: Tests of Price Cutting and Price Recovery", *The Accounting Review*, by D.T. Simon, and J.R. Francis, April 1988.

"Does Auditor Quality and Tenure Matter to Investors?" Evidence from the Bond Market. Sattar Mansi of Virginia Polytechnic Institute, William F. Maxwell of University of Arizona, and Darius P. Miller of Kelley School of Business, February 2003 paper under revision for the *Journal of Accounting Research*.

An Analysis of Restatement Matters: Rules, Errors, Ethics, for the Five Years Ended December 31, 2002, The Huron Consulting Group, January 2003.

The Commission on Auditors' Responsibilities: Report of Tentative Conclusions, The Cohen Commission (an independent commission established by the AICPA), 1977. (Limited to Section 9, "Maintaining the Independence of Auditors, Rotation of Auditors").

"Audit Fees and Auditor Change; An Investigation of the Persistence of Fee Reduction by Type of Change", *Journal of Business Finance and Accounting*, by A. Gregory, and P. Collier, January 1996.

"Auditor Changes and Tendering: UK Interview Evidence", *Accounting, Auditing and Accountability Journal*, v11n1, V. Beattie, and S. Fearnley, 1998.

Obtaining the Views of Public Accounting Firms and Public Company Chief Financial Officers and Their Audit Committee Chairs on Mandatory Audit Firm Rotation

We analyzed the issues identified from our review of studies, articles, position papers, and reports to develop an understanding of the background and related advantages and disadvantages of mandatory audit firm rotation. We developed three separate survey instruments incorporating a variety of issues related to auditor independence, audit quality, mandatory audit firm rotation and the potential effects on audit costs, audit fees, audit quality, audit risk, and competition that may arise with a mandatory audit firm rotation requirement. In addition, these survey instruments solicited views on the impact of specific provisions of the Sarbanes-Oxley Act intended to enhance auditor independence and audit quality, other practices for enhancing audit quality, views on implementing mandatory audit firm rotation, and overall opinions on requiring mandatory audit firm rotation.

We performed field tests of the survey instruments to help ensure that the survey questions would be understandable to different groups of respondents, eliminate factual inaccuracies, and obtain feedback and recommendations to improve the surveys. We took the feedback and comments we received into consideration in developing our final survey instruments. Specifically, during March and April of 2003, we performed field tests of the survey instrument for public accounting firms with eight different public accounting firms, including two of the Big 4 firms, two national firms, and four regional or local firms. During May 2003, we conducted field tests of the survey instrument for public company chief financial officers with four public companies, including two Fortune 1000 companies and two commercial banks not included in the Fortune 1000. We tailored the survey instrument for public company audit committee chairpersons by incorporating the feedback and comments we received from the chief financial officers during the field tests we performed with public companies.

Surveys of Public Accounting Firms

Section 207 of the Sarbanes-Oxley Act mandated that GAO study the potential effects of mandatory audit firm rotation of registered public accounting firms, referring to public accounting firms that would be registered with the new PCAOB. During the January 2003 time frame when we were framing the population, since the PCAOB was in the process of getting organized and becoming operational, there were no public accounting firms registered with the PCAOB at that time.[2] Therefore, we coordinated with the AICPA to establish a population of public accounting firms that would most likely register with the PCAOB. The AICPA provided a complete list of the more than 1,100 public accounting firms that were registered with the AICPA's Securities and Exchange Commission Practice Section (SECPS)[3] as of January 2003. Prior to the restructuring of the SECPS, AICPA bylaws required that all members that engage in the practice of public accounting with a firm auditing one or more SEC clients join the SECPS. Public accounting firms that did not have any SEC clients could join the SECPS voluntarily. Based on the information submitted in their 2001 annual reports, these SECPS member firms collectively had nearly 15,000 SEC clients.[4] Therefore, the public accounting firms registered with the SECPS at that time were used to frame an alternative source of public accounting firms that perform audits of issuers registered with the SEC.

Based on the AICPA-provided SECPS membership list and the number of SEC clients reported in these SECPS member firms' 2001 annual reports, of 1,117 SECPS members, 696 firms had 1 or more SEC clients and 421 firms were SECPS members but did not audit any public companies. The 696

[2] The PCAOB established the process for public accounting firms to register with the PCAOB starting in April 2003, with public accounting firms having an initial opportunity to register with the PCAOB no later than October 22, 2003. As of October 22, 2003, according to the PCAOB, there were 598 public accounting firms registered with the PCAOB and 55 public accounting firms that had applications pending the PCAOB's review.

[3] The AICPA's SECPS was a part of the former self-regulatory system. SECPS was overseen by the former Public Oversight Board (POB), which represented the public interest on all matters affecting public confidence in the integrity of the audit process. The SECPS required AICPA member accounting firms registered with the SECPS to subject their professional practices to peer review and oversight by the POB and SEC. The AICPA recently announced a new voluntary membership called the Center for Public Company Audit Firms that restructures and replaces the SECPS, which had several of its functions absorbed into the PCAOB.

[4] According to SEC records, there were nearly 18,000 issuers registered with the SEC as of February 2003.

members of the SECPS collectively audited 14,928 of the 17,956 issuers registered with the SEC. Since approximately 3,000 issuers were audited by public accounting firms that were not members of the SECPS, we obtained a list from the SEC that included the names of over 1,000 public accounting firms that performed the audits of public companies registered with the SEC. We compared the 696 SECPS member firms to all of the public accounting firms that were included in the SEC's list in order to identify the non-SECPS member public accounting firms, which were mainly consisted of foreign public accounting firms or domestic firms that are not AICPA members. Since the PCAOB has indicated that it will not exempt foreign public accounting firms that audit issuers registered with the SEC from registering with the PCAOB, we included non-SECPS member public accounting firms that reported to the SEC that they had 10 or more SEC clients in the population.

Stratification of Public Accounting Firm Population

In order to identify differences in views on the potential effects of mandatory audit firm rotation for respondents that vary based on the size of the public accounting firm, location (e.g., domestic versus foreign firms) and other factors, we stratified the population into three tiers based on the number of SEC clients reported to the SECPS in the SECPS member firms' 2001 annual reports and the aforementioned SEC data for non-SECPS member public accounting firms:

1. Tier 1 firms: 92 SECPS member and 5 non-SECPS public accounting firms that had 10 or more 2001 SEC clients in 2001,

2. Tier 2 firms: 604 SECPS member firms that had from 1 to 9, 2001 SEC clients in 2001, and

3. Tier 3 firms: 421 SECPS member firms that reported having no SEC clients.

The basis for selecting public accounting firms with 10 or more SEC clients was twofold. First, the 92 SECPS member firms included in Tier 1 collectively had approximately 90 percent of all of the SEC clients reported to the SECPS in the member firms' 2001 annual reports. Second, the public accounting firms with 10 or more SEC clients were viewed to collectively have the most experience and knowledge about changing auditors for public company clients and accordingly were considered to have a great interest in the potential effects of mandatory audit firm rotation. Tier 2 was established because the 604 SECPS member firms with 1 to 9 SEC clients comprises approximately 10 percent of the total SEC clients reported to the the SECPS in member firms' 2001 annual reports and were also considered to have a great interest in, as well as important views on, the potential effects of mandatory audit firm rotation based on their experience and knowledge of being auditors for public companies. Lastly, we included the 421 SECPS member public accounting firms that had no SEC clients in Tier 3 of our population in order to determine if there would be greater or less interest in providing financial statement audit services to public companies if mandatory audit firm rotation were required. We requested that the public accounting firms' chief executive officers or managing partners, or their designated representatives, complete the survey.

Method of Administration

In order to conduct our survey, we selected a 100 percent certainty sample of Tier 1 public accounting firms consisted of all 92 SECPS member firms and all 5 non-SECPS member firms. In addition, we selected separate random samples from each of the two remaining strata. We created two separate Web sites for the public accounting firm surveys. The top tier firms were surveyed independently of the second and third tiers because the Tier 1 survey was administered jointly with another study dealing with consolidation of major public accounting firms since 1989 as mandated by Section 701 of the Sarbanes-Oxley Act.[5] The survey for the Tier 2 and Tier 3 firms, which dealt only with the potential effects of mandatory audit firm rotation, was created at a separate Web site. A unique password and user ID was assigned to each selected public accounting firm in our sample to facilitate completion of the survey online. The surveys were made available to the Tier 1 firms during the week of May 27, 2003, and the surveys to the Tier 2 and Tier 3 firms were made available during the week of June 12, 2003. Both survey Web sites remained open until September 2003. Responses to surveys completed online were automatically stored on GAO's Web sites. From August through September 2003, we performed follow-up efforts to increase the overall response rates by telephoning the selected public accounting firms that had not completed the survey, and requested that they take advantage of the opportunity to express their views on this important issue by doing so.

Lastly, in order to gain knowledge about whether the views of the Tier 1 public accounting firms that did not complete our survey were materially

[5] U.S. General Accounting Office, *Public Accounting Firms: Mandated Study on Consolidation and Competition*, GAO-03-864 (Washington, D.C.: July 30, 2003).

different from the overall views of the Tier 1 public accounting firms that completed our survey, we asked the following key questions of those public accounting firms that did not complete our survey and that we contacted during our telephone follow-up efforts. Specifically, we asked whether their firms believed the benefits of mandatory audit firm rotation would exceed the costs of implementing such a requirement and whether their firms would support requiring mandatory audit firm rotation. As more fully described in the body of this report, the overall views expressed by the Tier 1 public accounting firms that completed our survey generally indicated that the costs of mandatory audit firm rotation would exceed the benefits and that their firms were not in favor of supporting such a requirement. The views of the Tier 1 public accounting firms that did not complete our survey and that we contacted in our telephone follow-up efforts were generally consistent with the overall views of the Tier 1 public accounting firms that completed our survey.

Public Accounting Firm Survey Results

As disclosed in our survey instruments, all survey results were to be compiled and presented in summary form only as part of our report, and we will not release individually identifiable data from these surveys, unless compelled by law or required to do so by the Congress. We received responses from 74 of the 97 Tier 1 firms, or 76.3 percent.[6] Because of the more limited participation of Tier 2 firms (85, or 30.1 percent) and Tier 3 firms (52, or 21.9 percent) in our survey, we are not projecting their responses to the population of firms in these tiers. The presentation of this report focuses on the responses from the Tier 1 firms, but any substantial differences in their overall views and those reported to us by either Tier 2 or 3 firms are discussed where applicable.

Table 2 summarizes the population, sample sizes, and overall responses received for all three tiers of public accounting firms surveyed on the potential effects of mandatory audit firm rotation.

[6] Estimates of Tier 1 firms are subject to sampling errors of no more than plus or minus 7 percentage points (95 percent confidence level) unless otherwise noted, as well as to possible nonsampling errors generally found in surveys.

Table 2: Public Accounting Firms' Population, Sample Sizes, and Survey Response Rates

	Tier 1 firms	Tier 2 firms	Tier 3 firms	Totals
Population size	97	604	421	**1,122**
Sample size	97	282	237	**616**
Total responses	74	85	52	**211**
Response rate	76.3%	30.1%	21.9%	**- - -**

Source: GAO survey data.

Surveys of Public Company Chief Financial Officers and Audit Committee Chairs

As a part of fulfilling our objective to study the potential effects of mandatory audit firm rotation, we obtained the views on the advantages and disadvantages and related costs and benefits from a random sample of chief financial officers and audit committee chairs of public companies registered with the SEC. We solicited the views of chief financial officers of public companies because they were considered to be very knowledgeable about the issues involving financial statement audits of public companies. We also solicited the views of audit committee chairs because under the Sarbanes-Oxley Act, the audit committee has expanded responsibilities for monitoring and overseeing public companies' financial reporting and the financial statement audit process. We obtained such views by administering a survey to randomly selected samples of public company chief financial officers and their audit committee chairs.

Section 207 of the Sarbanes-Oxley Act defines "mandatory rotation" as the imposition of a limit on the period of years for which a particular registered public accounting firm may be the auditor of record for a particular issuer. Therefore, in framing the population from which we planned to draw our sample of public companies, we researched what the definition of an "issuer" is with the SEC, with GAO's General Counsel, and the AICPA's SECPS. The primary purpose of conducting this research was to determine whether mutual funds (or mutual fund complexes) and other types of investment companies such as investment trusts, should be included in the population. Based on discussions with the Director of the SEC's Office of Investment Management, mutual funds and investment trusts are issuers that are required to file periodic reports with the SEC under the Securities Exchange Act of 1934 or the Investment Company Act of 1940. Also, officials in the SEC's Office of Investment Management indicated that there are nearly 10,000 individual mutual funds grouped into 877 mutual fund complexes (also known as families). A mutual fund complex is responsible for hiring the auditor of record, either collectively or individually, for the individual mutual funds that are included in the family or complex. As such, investment trusts and the 877 mutual fund complexes were included in our population for the purpose of administering our survey.

We obtained lists of public company issuers from the SEC in developing the population as follows: The SEC's Office of Corporation Finance provided a list of 17,079 public companies from the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. This list included registrants that were listed as current issuers registered with the SEC as of February 2003 and included 14,938 domestic public companies (including investment trusts) and 2,141 foreign public companies (i.e., companies that are domiciled outside of the United States but are registered with the SEC). Our comparison of this SEC list to a separate list of Fortune 1000 companies identified an additional 32 public companies that were added to the original list of 17,079, bringing the total population to an adjusted total of 17,111. As noted above, we also obtained a complete list of 877 mutual fund complexes from the SEC that included current issuers registered with the SEC's Office of Investment Management. Therefore, the population of public company issuers as of February 2003 totaled 17,988, consisted of 17,111 public companies and 877 mutual fund complexes.

Stratification of Chief Financial Officer and Audit Committee Chair Population

In order to identify differences in views on the potential effects of mandatory audit firm rotation based on differences in company industry, size, or geographic location, we stratified the population into the following three strata: (1) domestic Fortune 1000 companies, (2) other (non-Fortune 1000) domestic companies and mutual fund complexes, and (3) foreign companies.

Fortune 1000 stratum: Based on Fortune's list of the Fortune 1000 as of March 2003, we identified 960 public companies in the Fortune 1000; the remaining 40 companies were privately owned. Since private companies are not subject to SEC rules or the Sarbanes-Oxley Act's provisions, these 40 companies were not included in the stratum. We used the file provided by the SEC listing the 17,079 domestic and foreign public companies to extract a separate stratum of the 960 public companies in the Fortune 1000. In addition, in comparing Fortune's list of the Fortune 1000 to the SEC's listing of public companies, we identified 32 additional companies that were included in the Fortune 1000 but which were not included in the SEC list. In connection with framing the Fortune 1000 stratum, we added these

32 companies to the list of domestic and foreign public companies provided to us by the SEC to ensure that it was complete.

Foreign company stratum: Using the "state code" identifier included in the adjusted SEC list of 17,111 domestic and foreign public companies, we extracted a separate stratum of 2,141 foreign companies.

Other domestic companies and mutual fund complexes stratum: After extracting the 960 domestic Fortune 1000 public companies and the 2,141 foreign public companies from the adjusted SEC list of 17,111 domestic and foreign public companies, a separate stratum of 14,010 non-Fortune 1000 public companies was created from the SEC file representing the "other domestic" public companies. These 14,010 other domestic public companies (which included investment trusts) were combined with the 877 mutual fund complexes provided by the SEC's Office of Investment Management to create a total population for this stratum of 14,887.

Method of Administration

In order to conduct these surveys, we selected a separate random sample from each of the three public company strata. We mailed a survey package to the chief financial officer of each public company issuer included in our sample. This survey package provided the chief financial officer with the option of completing the enclosed hard copy of the survey and returning it in the mail to our Atlanta Field Office or of completing the survey online. We created a Web site with the public company survey for the chief financial officers. A unique password and user ID was assigned to each selected company in our sample of companies to facilitate completion of the survey online. In addition, a separate survey directed to the chair of the audit committee (or head of an equivalent body) was included in the mail survey package. The chief financial officer was asked to forward this survey to the audit committee chair. The survey for the public company audit committee chairs was not made available online. As such, these surveys could only be completed on hard copy and returned to our Atlanta Field Office. The survey packages were mailed to all 1,171 public companies in June 2003. The survey Web site for public company chief financial officers remained open until September 2003. The cutoff date for accepting mailed surveys from public company chief financial officers and audit committee chairs was September 2003. Responses to surveys completed online were automatically stored into GAO's Web sites, and mailed survey responses of chief financial officers and audit committee chairs were entered into a separate compilation database by GAO contractor personnel who were hired to perform such data inputting. From

August through September 2003, we also performed follow-up efforts to increase the overall response rates by telephoning public company chief financial officers, who had not completed or returned the survey, and requesting that the chief financial officer and the audit committee chair complete our survey and return it to us.

Public Company Survey Results

As disclosed in our surveys, all survey results were to be compiled and presented in summary form only as part of our report, and we will not release individually identifiable data from these surveys, unless compelled by law or required to do so by the Congress. Of the 330 Fortune 1000 public companies sampled, we received responses from 201, or 60.9 percent, of their chief financial officers and 191, or 57.9 percent, of their audit committee chairs.[7] Because of limited participation of the other domestic companies and mutual funds (131, or 29.1 percent, of their chief financial officers and 96, or 21.3 percent, of their audit committee chairs) and the foreign public companies (99, or 25.3 percent, of their chief financial officers and 63, or 16.1 percent, of their audit committee chairs), we are not projecting their responses to the population of companies in these strata. The presentation of this report focuses on the responses from the Fortune 1000 public companies' chief financial officers and their audit committee chairs, but any substantial differences in their overall views and those reported to us by the other groups of public companies we surveyed is discussed where applicable.

Tables 3 and 4 summarize the population, sample size, and survey responses received for all three strata of public company chief financial officers and their audit committee chairs surveyed on the potential effects of mandatory audit firm rotation.

[7] The estimates from these surveys are subject to sampling errors of no more than plus or minus 6 percentage points (95 percent confidence level) unless otherwise noted, as well as to possible nonsampling errors generally found in surveys.

Table 3: Public Company Chief Financial Officers' Population, Sample Sizes, and Survey Response Rates

	Fortune 1000 companies	Domestic public companies and mutual funds	Foreign public companies	Totals
Population size	960	14,887	2,141	**17,988**
Sample size	330	450	391	**1,171**
Total responses	201	131	99	**431**
Response rate	60.9%	29.1%	25.3%	**- - -**

Source: GAO survey data.

Table 4: Public Company Audit Committee Chairs' Population, Sample Sizes, and Survey Response Rates

	Fortune 1000 companies	Domestic public companies and mutual funds	Foreign public companies	Totals
Population size	960	14,887	2,141	**17,988**
Sample size	330	450	391	**1,171**
Total responses	191	96	63	**350**
Response rate	57.9%	21.3%	16.1%	**- - -**

Source: GAO survey data.

Additional Survey Considerations

We initially requested information from all 97 Tier 1 firms (firms with 10 or more SEC clients). We received responses from 74 of them. We conducted follow-up with a limited number of the nonrespondents and did not find substantive differences between the respondents and the nonrespondents on key questions related to mandatory audit firm rotation. We requested information from 330 Fortune 1000 public companies and their audit committee chairs and received 201 and 191 responses from them, respectively. While we did not conduct follow-up with the nonrespondents from our surveys of Fortune 1000 public companies and their audit committee chairs, we had no reason to believe that respondents and nonrespondents to our original samples from these strata would substantively differ on issues related to mandatory audit firm rotation. Therefore, we analyzed respondent data from the Tier 1 and Fortune 1000 public companies and their audit committees as probability samples from these respective populations.

Survey results based on probability samples are subject to sampling error. Each of the three samples (Tier 1 and Fortune 1000 public companies and their audit committee chairs) is only one of a large number of samples we might have drawn from the respective populations. Since each sample could have provided different estimates, we express our confidence in the precision of our three particular samples' results as 95 percent confidence intervals. These are intervals that would contain the actual population values for 95 percent of the samples we could have drawn. As a result, we are 95 percent confident that each of the confidence intervals in this report will include the true values in the respective study populations. All percentage estimates from the survey of Tier 1 firms have sampling errors not exceeding +/- 7 percentage points unless otherwise noted. All percentage estimates from the surveys of Fortune 1000 public companies and their audit committee chairs have sampling errors not exceeding +/- 6 percentage points unless otherwise noted. Also, estimated percentages for subgroups of Tier 1 firms and Fortune 1000 public companies and their audit committee chairs often have sampling errors exceeding these thresholds, which are noted where they are reported. In addition, all numerical estimates other than percentages have sampling errors of not more than +/- 14 percent of the value of those numerical estimates.

Despite our judgment that respondents and nonrespondents do not differ on issues related to mandatory audit firm rotation, our survey estimates may nevertheless contain errors to the extent that there truly are differences between these groups on issues related to this topic.

The practical difficulties of conducting any survey also introduce other types of nonsampling errors. Differences in how a particular question is interpreted and differences in the sources of information available to respondents can also be sources of nonsampling errors. We included steps in both the data collection and data analysis stages to minimize such nonsampling errors. These steps included developing our survey questions with the aid of our survey specialists, conducting pretests of the public accounting firm and public company questions and questionnaires, verifying computer analysis by an independent analyst, and double verification of survey data entry where applicable.

Discussions Held with Officials of Other Interested Stakeholders

To supplement the responses to our survey, we identified other knowledgeable individuals associated with a broad range of communities of interest and conducted telephone or in-person discussions to obtain their views on mandatory audit firm rotation. The communities of interest included significant institutional investors (pension funds, mutual funds, and insurance companies), self-regulatory organizations (such as stock exchanges), consumer advocacy groups, regulators (state boards of accountancy, banking regulators), the AICPA, the SEC, the PCAOB, and recognized experts in corporate governance.

The questions for these discussions were based on key questions from the surveys for public accounting firms and public companies. The results of the discussions were compiled and presented in summary form only as part of our report, and we will not release individually identifiable data from these discussions, unless compelled by law or required to do so by the Congress.

Obtaining Information from Other Countries on Their Experiences with Mandatory Audit Firm Rotation

In order to obtain other countries' current or previous experience with or consideration of mandatory audit firm rotation, we administered surveys to the securities regulators of the Group of Seven Industrialized Nations (G-7), which included the United Kingdom, Germany, France, Japan, Canada, and Italy. In addition to the G-7 countries' securities regulators, we also administered surveys to the following members of the International Organization of Securities Commissions (IOSCO)[8]: Australia, Austria, Belgium, Brazil, China, Hong Kong, Luxembourg, Mexico, the Netherlands, Singapore, Spain, Sweden, and Switzerland. The IOSCO members represent these foreign countries' organizations with duties and responsibilities similar to those of the SEC in the United States.

We administered the surveys to these foreign countries' securities regulators in December 2002. From July and through October 2003, we performed follow-up efforts to increase the overall response rates by sending e-mail messages to the foreign countries' securities regulators in our sample who had not completed the survey and requested that they do so. We received responses from 11 of the 19 countries' securities regulators surveyed.

[8] IOSCO is an international association of securities regulators that was created in 1983 to promote high standards of regulation in order to maintain just, efficient, and sound markets; promote the development of domestic markets; establish standards and an effective surveillance of international securities transactions; and promote the integrity of the markets by rigorously applying the standards and by effectively enforcing them.

Identifying Restatements of Annual Financial Statements for Fortune 1000 Public Companies due to Errors or Fraud

To obtain some insight into the potential value of the “fresh look” provided by a new auditor of record, we analyzed the rate of annual financial statement restatements reported to the SEC by Fortune 1000 public companies during 2002 and 2003 through August 31, 2003. We particularly focused on restatements for 2001 and 2002 and compared the financial statement restatement rates of those Fortune 1000 public companies that changed their auditor of record to those of Fortune 1000 public companies that did not change their auditor of record during this period.

In connection with performing this analysis, we separately tracked the Fortune 1000 public companies that changed auditors from the public companies that did not change auditors during 2001 and 2002. Financial statement restatements filed for changes in accounting principles or changes in organizational business structure (e.g., stock splits, mergers and acquisitions), reclassifications, or to compliance with SEC reporting requirements are not necessarily indications of compromised audit quality or auditor independence. However, financial statement restatements due to errors or fraud raise doubt about the integrity of management’s financial reporting practices, the quality of the audit, or the auditor’s independence. Therefore, the focus of our analysis was on annual financial statement restatements (hereinafter referred to as “restatements”) due to errors or fraud. Since not all restatements are indications of errors or fraud, we reviewed Form 10-KAs[9] (amended 10-K filings), Form 8-Ks, and any related SEC enforcement actions to determine if the restatements were due to errors or fraud. The primary purpose of this test was to determine whether the rate of restatements due to errors or fraud of companies that changed auditors was higher or lower than the rate of restatements due to errors or fraud of companies that did not change auditors.

For each of the Fortune 1000 companies, we searched SEC's EDGAR system for Form 10-KA filings submitted to the SEC during 2002 and 2003 through August 31, 2003, that amended either 2001 or 2002 financial statements to identify annual financial statement restatements. We determined if there had been a change in auditor from 2001 through 2002 by reviewing the name of the auditor of record on the audit opinion included in the Form 10-KA filed for 2001 and 2002, and also noted what type of audit opinion was issued on the 2001 and 2002 financial statements. This allowed us to identify the restatements associated with Fortune 1000 public companies that changed auditors and the restatements of Fortune 1000 public companies that did not change auditors. We compared the level of restatements for Fortune 1000 public companies that changed auditors to the level of restatements of Fortune 1000 public companies that did not change auditors.

[9] We focused on Form 10-KA filings because they include the actual restatements of previously issued annual financial statements included in the original Form 10-K. While amended quarterly filings (Form 10-QA) and Form 8-K filings may include disclosures of a public company's intention to restate previously issued annual financial statements, we did not consider Form 10-QA or Form 8-K filings for the purpose of identifying restatements of annual financial statements. Public companies may announce via a Form 10-Q or a Form 8-K that the company is going to restate in the near future, but then not file restated financial statements with the SEC because it may file for bankruptcy or become delisted. Therefore, we intentionally limited our review of the SEC's EDGAR system to identifying restatements of annual financial statements that were filed with the SEC during 2002 and 2003 through August 31, 2003. However, we also identified annual restatements of those Fortune 1000 public companies that included restatements in their annual Form 10-K filings. In addition, some public companies (such as Freddie Mac, WorldCom, Qwest, and Enron) and their auditors may still be in the process of determining the required adjustments and developing appropriate disclosures before they can file the restatement of previously issued annual financial statements via Form 10-KA to the SEC. Lastly, since we reviewed the Form 10-KA filings for 2002 that had been submitted to the SEC through August 31, 2003, the results of our analysis reflect restatements that have been submitted to the SEC through that date and therefore do not include or reflect restatements that may be filed in the future by any public companies that plan to restate previously issued financial statements or any public companies that may not yet be aware of a need to restate previously issued annual financial statements.

For each of the restatements identified above, we reviewed underlying Form 10-KA (amended 10-K filings), Form 8-Ks, and any related SEC enforcement actions to quantify the dollar effect of the restatements and to determine if the restatements were due to errors or fraud. We differentiated restatements caused by errors or fraud from restatements caused by changes that were not indications of compromised audit quality or auditor independence, such as changes in accounting principles, mergers, stock splits, and reclassifications using appropriate classification criteria. In addition, we attempted to ascertain from the above sources whether company management, the predecessor auditor, or the successor auditor identified the error or fraud, and where applicable, whether it was identified before or after the change in auditor.

After categorizing the 2001 and 2002 Fortune 1000 public companies' annual financial statement restatements and annual financial statement filings into (1) companies that did not change auditors and filed a restatement, (2) companies that did not change auditors and did not file a restatement, (3) companies that changed auditors and filed a restatement, and (4) companies that changed auditors and did not file a restatement, we compared the rates of restatements among and between these groups.

Implementation of Mandatory Audit Firm Rotation, if Required

If mandatory audit firm rotation were required, a number of implementing factors affecting the structure of the requirement would need to be decided. As a component of our surveys of public accounting firms, public companies, and their audit committee chairs, we asked them to provide their views on various implementing factors, regardless of whether they supported mandatory audit firm rotation, including

- the limit on the incumbent firm's audit tenure period,
- the "cooling off" period before the incumbent firm could again compete to provide audit services to the public company,
- under what circumstances either the audit committee or the public accounting firm could terminate the relationship for providing audit services,
- whether mandatory audit firm rotation should be implemented on a staggered basis, and
- whether mandatory audit firm rotation should be required for audits of all public companies, and if not, to which public companies should it be applied.

Time Limit on the Auditor of Record's Tenure

Regarding the limit on the auditor of record's tenure under mandatory audit firm rotation, about 47 percent of Tier 1 firms stated that the limit should be 8 to 10 years. Fortune 1000 chief financial officers and audit committee chairs selected 8 to 10 years about as often as 5 to 7 years as the limit on the auditor of record's tenure. Tiers 2 and 3 firms and other public companies' audit committee chairs that responded to our surveys generally favored an audit tenure of 5 to 7 years.

Time Limit Before the Auditor of Record Could Compete to Provide Audit Services to the Public Company Previously Audited

Most Tier 1 firms and Fortune 1000 public company chief financial officers and their audit committee chairs believed the "cooling off" period under mandatory audit firm rotation should be 3 or 4 years before the auditor of record could again compete to provide audit services to the public company previously audited.

Circumstances When the Audit Committee or the Auditor of Record Could Terminate the Business Relationship Providing Audit Services

Nearly all Tier 1 firms and Fortune 1000 public company chief financial officers and their audit committee chairs stated that the audit committee under mandatory audit firm rotation should be permitted to terminate the auditor of record at any time if it is dissatisfied with the public accounting firm's performance or working relationship. Most Tier 1 firms and Fortune 1000 public company chief financial officers and their audit committee chairs also believed that the auditor of record should be able to terminate its relationship with the audit committee/public company at any time if the public accounting firm is dissatisfied with the working relationship.

Period for Implementing Mandatory Audit Firm Rotation

Nearly all Tier 1 firms and Fortune 1000 public company chief financial officers and their audit committee chairs believed that mandatory audit firm rotation should be implemented over a period of years (staggered) to avoid a significant number of public companies changing auditors simultaneously.

Public Companies for Which Auditor of Record Should Be Subject to Mandatory Audit Firm Rotation

About 70 percent of Tier 1 firms believed that mandatory audit firm rotation should not be applied uniformly for audits of all public companies regardless of their nature or size. In contrast, about 81 percent of Fortune 1000 public companies and 65 percent of their audit committee chairs believed that mandatory audit firm rotation should be applied uniformly for audits of all public companies regardless of the nature or size. Most chief financial officers of other domestic and mutual fund public companies who responded to our survey believe mandatory audit firm rotation should be applied uniformly, and their audit committee chairs were split on the subject. Comments that we received from many of the Tier 1 firms, Fortune 1000 public companies, and their audit committee chairs that supported requiring that mandatory audit firm rotation be applied uniformly generally took the view that there should be a level playing field and that the benefits and the costs of mandatory audit firm rotation should be applied to all public companies. In contrast, those who commented opposing requiring mandatory audit firm rotation for all public companies generally took the view that the smaller public companies are less complex and the costs of mandatory audit firm rotation would be more burdensome for the smaller companies.

We asked those public accounting firms and public company chief financial officers and their audit committee chairs who believed mandatory audit firm rotation should not be applied uniformly to all public companies to select by company nature and size to which companies mandatory audit firm rotation should apply. Tier 1 firms and Fortune 1000 audit committee chairs more frequently selected the larger public companies. However, Fortune 1000 chief financial officers were about evenly split in their views regardless of the size of the public company. Chief financial officers and their audit committee chairs of other domestic and mutual fund public companies, as well as foreign public company chief financial officers and their audit committee chairs, who responded to our survey more frequently selected the larger public companies.

Potential Value of Practices Other Than Mandatory Audit Firm Rotation for Enhancing Auditor Independence and Audit Quality

We asked public accounting firms, public companies' chief financial officers, and their audit committee chairs to provide their views on the potential value of the various following alternative practices we identified through our research and other inquiries made in developing our surveys versus the value of other than mandatory audit firm rotation for enhancing auditor independence and audit quality.

- *The audit committee periodically holding an open competition for providing audit services*: Having the audit committee periodically hold an open competition for public accounting firms to serve as the public company's auditor of record, in which the incumbent auditor of record could also compete, could potentially enhance auditor independence and audit quality by letting the incumbent firm know that it does not have unlimited tenure as the auditor of record and a lock on the associated revenues, and that another firm may be selected to provide a "fresh look" at the company's financial reporting process, practices, and financial statements. Also, the public company has an opportunity to see the quality of personnel that another public accounting firm could provide. However, the public company will incur some costs in holding such a competition and, if another firm is selected, may incur additional initial years' audit fees and will have additional auditor support costs to assist the new auditor of record in understanding the company's operations, systems, and financial reporting practices.

- *Requiring audit managers to periodically rotate off the engagement for providing audit services to the public company*: Audit manager is a senior position reporting to the engagement audit partner with responsibility for assisting the engagement audit partner in planning, conducting, and reporting on the audit of the public company's financial statements. Larger audits will likely have multiple audit managers and audit partners participating in the audit. Conceptually, periodically changing audit managers brings a "fresh look" to the audit assignment and the associated potential benefits. However, there is an associated learning curve that is likely to cause both the public accounting firm and the public company to incur some additional costs. Some public accounting firms commented that this practice already occurs as a result of career enhancement policies and practices of the firms.

- *The audit committee periodically obtaining the services of a public accounting firm to assist it in overseeing the financial statement audit or to conduct a forensic audit in areas of the public company's financial reporting process that present a risk of fraudulent financial* *reporting*: Overseeing the auditor of record's conduct of the financial statement audit is a significant responsibility that is especially challenging depending on the size and complexity of a public company. Having another public accounting firm as needed to assist the audit committee brings a "fresh look" to help the audit committee understand the public company's operations, systems, and financial reporting practices and the underlying internal controls and risks. Also, as areas are identified that may have greater risk of fraudulent financial reporting, the audit committee may wish to have a public accounting firm conduct a forensic audit to provide both a "fresh look" and a more penetrating audit of transactions and related internal controls and financial reporting practices in areas of high risk. Additional costs will be incurred by the audit committee, and some degree of coordination and cooperation of the incumbent audit firm will be necessary, which will also add to the audit committee's responsibilities.

- *Requiring that the auditor of record be hired on a noncancelable multiyear basis, although the public accounting firm could terminate the relationship for cause during the contract period*: Having the audit committee hire the auditor of record on a multiyear basis that only the auditor of record can cancel potentially enhances auditor independence and audit quality by assisting the auditor in dealing with any pressures from management in appropriately dealing with financial reporting practices that may materially affect the financial statements. However, this practice takes away flexibility of the audit committee to replace the auditor of record within the period of the contract should the audit committee be dissatisfied with the auditor of record's performance.

Although many Tier 1 firms, Fortune 1000 public companies, and their audit committee chairs saw some benefit in each of the alternative practices, in general, they most frequently reported that the alternative practices would have limited or little benefit. The most notable exception involved the practice in which audit committee would hire the auditor of record on a noncancelable multiyear basis, for which most Fortune 1000 public companies and their audit committee chairs reported that the practice would have no benefit. (See table 5.)

Table 5: Views on Potential Value of Other Practices for Enhancing Auditor Independence and Audit Quality

Numbers in percentages

	Significant or very positive benefit	Limited or little benefit	No benefit
Practice 1: Audit committee periodically holding open competition for providing audit services			
Tier 1 firms	11	44	45
Fortune 1000 public companies	11	53	36
Fortune 1000 audit committee chairs	23	53	24
Practice 2: Requiring periodic rotation of audit managers			
Tier 1 firms	14	57	29
Fortune 1000 public companies	24	48	28
Fortune 1000 audit committee chairs	42	46	12
Practice 3: Audit committee periodically obtaining service of a public accounting firm to assist in overseeing the financial statement audit			
Tier 1 firms	20	53	27
Fortune 1000 public companies	10	42	48
Fortune 1000 audit committee chairs	13	59	28
Practice 4: Audit committee periodically obtaining service of a public accounting firm to conduct a forensic audit			
Tier 1 firms	30	46	24
Fortune 1000 public companies	13	50	37
Fortune 1000 audit committee chairs	19	61	20
Practice 5: Audit committee hiring auditor of record on a noncancelable multiyear basis			
Tier 1 firms	22	48	30
Fortune 1000 public companies	5	34	61
Fortune 1000 audit committee chairs	6	37	57

Source: GAO analysis of survey data.

Restatements of Annual Financial Statements for Fortune 1000 Public Companies Due To Errors or Fraud

To obtain some insight into the potential value of the "fresh look" provided by a new auditor of record, we analyzed the rate of annual financial statement restatements reported to the Securities and Exchange Commission (SEC) by Fortune 1000 public companies during 2002 and 2003 through August 31, 2003. We particularly focused on restatements for 2001 and 2002 and compared the financial statement restatement rates of those Fortune 1000 public companies that changed their auditor of record to those Fortune 1000 public companies that did not change their auditor of record during this period.

Historically, only about 3 percent of public companies change auditors in any given year.[1] However, we observed that 2.9 percent (28 out of 960[2]) of the Fortune 1000 public companies changed auditors during 2001 and 21.3 percent (204 out of 960) of the Fortune 1000 public companies changed auditors during 2002. The significant increase from 2001 through 2002 was primarily due to the dissolution of Arthur Andersen LLP in 2002, which was caused, in part, by its criminal indictment for obstruction of justice stemming from its role as auditor of Enron Corporation. Since many of these public companies had to replace Andersen as their auditor of record during 2002, the number of changes in their auditor of record effectively represented a partial form of mandatory audit firm rotation.

Tables 6 and 7 summarize the occurrence of the reported Fortune 1000 public companies' restatement filings.

[1] R. Doogar (University of Illinois, Urbana-Champaign) and R. Easley and D. Ricchiute (University of Notre Dame), "Switching Costs, Audit Firm Market Shares and Merger Profitability," (Nov. 20, 2001), which was discussed in GAO-03-864, cited a level of 2.7 percent annual client switching of auditors based on prior research the authors performed using 1981-1997 *Compustat* data.

[2] We identified 960 public companies included in the Fortune 1000 for the purpose of developing our sampling approach for administering the public company surveys, that is, in framing the upper stratum of the population universe.

Table 6: Summary Results of the Fortune 1000 Public Companies That Changed Auditors

Number of companies with restatements due to	2001	2002
Rules based changes	0	0
Errors	3	7
Fraud	0	1
Restatements related to companies that changed auditors	3	8
Fortune 1000 public companies that changed auditors	28	204
Restatement rate for companies that changed auditors	10.7%	3.9%

Source: GAO analysis of restatements.

Table 7: Summary Results of the Fortune 1000 Public Companies That Did Not Change Auditors

Number of companies with restatements due to	2001	2002
Rules based changes	2	1
Errors	21	8
Fraud	2	1
Restatements related to companies that did not change auditors	25	10
Fortune 1000 public companies that did not change auditors	932	756
Restatement rate for companies that did not change auditors	2.7%	1.3%

Source: GAO analysis of restatements.

The combined restatement rates from tables 6 and 7 for all Fortune 1000 public companies, including those that changed auditors and those that retained their auditor of record, was 2.9 percent in 2001 (28 restatements out of the 960 Fortune 1000 public companies) and 1.9 percent in 2002 (18 restatements out of the 960 Fortune 1000 public companies). The overall restatement rates are higher in 2001 than the comparable levels of restatements observed in 2002. This may be due to the fact that our analysis was limited to restatements submitted to the SEC on Form 10-KA filings for 2001 and 2002 through August 31, 2003. Some of the Fortune 1000 public companies that had not filed restatements with the SEC as of August 31, 2003, may still do so in the future. Additionally, because some companies may require considerable amounts of time and effort to unravel complex accounting and financial reporting issues (e.g., WorldCom, which is in the process of working its way out of bankruptcy proceedings, and the Federal Home Loan Mortgage Corporation, better known as Freddie Mac, which is working to restate 3 years of previously issued financial statements), it is reasonable to expect that additional restatements will be included in Form 10-KAs or other filings that had not been submitted to the SEC as of August 31, 2003.

Financial statement restatements filed for changes in accounting principles or changes in organizational business structure (e.g., stock splits, mergers and acquisitions), reclassifications, or compliance with SEC reporting requirements, referred to as “rules based changes,” are not necessarily indications of compromised audit quality or auditor independence. However, financial statement restatements due to errors or fraud raise doubt about the integrity of management’s financial reporting practices, the quality of the audits, and the auditor’s independence. Therefore, the following focus of our analysis was on annual financial statement restatements (hereinafter referred to as “restatements”) due to errors or fraud.

The rate of restatement due to errors or fraud for Fortune 1000 public companies that changed auditors were 10.7 percent in 2001 and 3.9 percent in 2002 compared to restatement rates due to errors or fraud of 2.5 percent in 2001 and 1.2 percent in 2002 for companies that did not change auditors. Although the data indicate that the overall restatement rate is approximately four[3] times higher in 2001 and three times higher in 2002[4] for those Fortune 1000 public companies that changed auditors than for those companies that did not change auditors, caution should be exercised as further analysis would be needed in order to determine whether the restatements are associated with the “fresh look” of the new auditor attributed to mandatory audit firm rotation. In that respect, in some cases we were able to determine from our review of the Form 10-KAs, any related Form 8-Ks, and the results of Internet news searches, that the restatements were identified as a result of an SEC investigation or an enforcement action. However, for the majority of the restatements we identified, the information included in the SEC’s EDGAR system did not provide sufficient information to ascertain whether company management, and in those

[3] The 10.7 percent rate of restatements due to errors or fraud of the Fortune 1000 public companies that changed auditors in 2001 was approximately 4.25 times higher than the 2.5 percent rate of restatements due to errors or fraud of the Fortune 1000 public companies that did not change auditors.

[4] The 3.9 percent rate of restatements due to errors or fraud of the Fortune 1000 public companies that changed auditors in 2002 was approximately 3.25 times higher than the 1.2 percent rate of restatements due to errors or fraud of the Fortune 1000 public companies that did not change auditors.

cases where there was a change in auditor, the predecessor auditor, or the successor auditor identified the error or fraud and whether it was identified before or after the change in auditor. Also, the recent corporate financial reporting failures have greatly increased the pressures on management and auditors regarding honest, fair, and complete financial reporting.

Effect of Restatements Due to Errors or Fraud

The phrase in an auditor's unqualified opinion, "present fairly, in all material respects, in conformity with generally accepted accounting principles," indicates the auditor's belief that the financial statements taken as a whole are not materially misstated. An auditor plans an audit to obtain reasonable assurance of detecting misstatements that could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements.[5] Financial statements are materially misstated when they contain misstatements the effect of which, individually or in the aggregate, is important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles. As previously noted, misstatements can result from errors or fraud. As defined in Financial Accounting Standards Board Statement of Financial Concepts No. 2, materiality represents the magnitude of an omission or misstatement of an item in a financial report that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the inclusion or correction of the item.

Table 8 summarizes the net dollar effect of the restatements due to errors or fraud on the reported net income (loss) of all 43 companies' previously issued annual financial statements for the fiscal years, calendar years, or both ended from 1997 through 2002.[6]

[5] Although the auditor should be alert for misstatements that could be qualitatively material, it ordinarily is not practical to design procedures to detect them. Section 326 of the AICPA's Statement on Auditing Standards states that "an auditor typically works within economic limits; his or her opinion, to be economically useful, must be formed within a reasonable length of time and at reasonable cost."

[6] The restatement of one of the 43 companies that submitted restatements due to errors or fraud related to financial statements that were originally issued in 1995. However, we were unable to quantify the dollar effect of the restatements associated with these financial statements because the SEC's EDGAR system did not include financial statements filed prior to 1997.

Table 8: Summary of Net Dollar Effect of Restatements Due to Errors and Fraud

Dollars in millions

	1997	1998	1999	2000	2001	2002
Net effect of restatements	($69.2)	($71.2)	($1,387.0)	($821.4)	($456.3)	($124.8)
Net income (loss), previously reported	$337.4	$316.4	$11,054.7	$12,234.2	($1,234.4)	($640.2)
Misstatement rate	(20.5)%	(22.5)%	(12.5)%	(6.7)%	(37.0)%	(19.5)%

Source: GAO analysis of restatements.

The misstatement rates associated with these 43 companies' previously issued statements of net income (loss), which ranged from a 6.7 percent overstatement of net income (loss) for 2000 to a 37.0 percent understatement of net income (loss) for 2001, would clearly be considered material enough to have affected the fair presentation of the results of operations included in these 43 companies' financial statements. Accordingly, it is probable that the judgment of a reasonable person relying on the information included in these companies' previously issued financial statements would have been changed or influenced by the inclusion of omitted information or correction of misstated items due to errors or fraud.

International Experience with Mandatory Audit Firm Rotation

Italy

Italy has required mandatory audit firm rotation of listed companies since 1975 in which the audit engagement may be retendered (recompeting for providing audit services) every 3 years and the same public accounting firm may serve as the auditor of record for a maximum of 9 years. In addition, there is a minimum time lag of 3 years before the predecessor auditor can return. The mandatory audit firm rotation requirement was intended to safeguard the independence of public accounting firms. In a meeting with IOSCO Standing Committee one member, the Italian representative from Commissione Nazionale per le Societa e la Borsa (CONSOB), the Italian securities regulator, indicated that Italy's experience with mandatory audit firm rotation has been a good one, noting that mandatory audit firm rotation gives the appearance of independence, which is considered very important to maintaining investor confidence. However, it was also noted that there have been negative impacts, when after 3 years, there is fee pressure by the listed company on the audit firm that contributes to reduced audit fees. In responding to our survey, CONSOB's representative indicated that there has been a progressive reduction in audit fees, which has given rise to concern over audit firms' ability to maintain adequate levels of audit services and quality control.

Research in Italy[1] concludes that mandatory audit firm rotation carries significant threats to audit quality from competitive pressures. However, the CONSOB raised concerns about the study's methodology, accuracy, data used, and appropriateness of the conclusions. Our review of the executive summary of the study also identified potential limitations on the reliability of data used and methodological concerns that created uncertainties about the study's conclusions.[2] Italy has also considered partner rotation; however, because Italy is currently considering reducing the maximum auditor tenure from 9 years to 6 years, partner rotation has not been given further consideration.

[1] SDA *Universita Bocconi* Corporate Finance and Real Estate Department and Administration and Control Department, *The Impact of Mandatory Audit Rotation on Audit Quality and on Audit Pricing: The Case Of Italy* (Executive Summary).

[2] The authors of the SDA Universita Bocconi study did not respond to our request to provide us additional information about the reliability of data that were used and the methodological approach.

Brazil

Brazil enacted a mandatory audit firm rotation requirement in May 1999 with a 5-year maximum term and minimum time lag of 3 years before the predecessor auditor of record can return. The Comissao de Valores Mobiliarios (CVM), which is the Brazilian Securities Commission, indicated that the primary reason mandatory audit firm rotation was enacted was to strengthen audit supervision following accounting fraud at two banks (Banco Economico and Banco Nacional). Brazil does not have a partner rotation requirement, as the CVM believes that the requirement of rotating audit firms is stronger than changing partners within firms. However, as a component of its mandatory audit firm rotation requirement, Brazil prohibits an individual auditor who changes audit firms to audit the same corporations previously audited.

Singapore

Starting in March 2002, the Monetary Authority of Singapore stipulated that banks incorporated in Singapore should not appoint the same public accounting firm for more than 5 consecutive financial years. However, this requirement does not apply to foreign banks operating in Singapore. Banks incorporated in Singapore that have had the same public accounting firm for more than 5 years have until 2006 to change their audit firms. While a “time out” period is not stipulated, banks incorporated in Singapore shall not, except with the prior written approval of the Monetary Authority of Singapore, appoint the same audit firm for more than 5 consecutive years. In addition, listed companies are required under the Listing Rules of the Singapore Exchange to rotate audit partners-in-charge every 5 years.

The primary reason Singapore instituted mandatory audit firm rotation for local banks was to promote the independence and effectiveness of external audits. In addition, mandatory audit firm rotation for local banks was cited by Singapore’s officials as a measure to help (1) safeguard against public accounting firms having an excessive focus on maintaining long-term commercial relationships with the banks they audit, which could make the firms too committed or beholden to the banks, (2) maintain the professionalism of audit firms—where with long-term relationships, audit firms run the risk of compromising their objectivity by identifying too closely with the banks’ practices and cultures, and (3) bring a fresh perspective to the audit process—where with long-term relationships, public accounting firms might become less alert to subtle but important changes in the bank’s circumstances.

Austria

In Austria, Austrian Commercial Law will require mandatory audit firm rotation every 6 years to strengthen the quality of audits and to enhance auditor independence by limiting the time of doing business between the audited company and its auditor of record. The 6-year mandatory audit firm rotation requirement will become effective from the beginning of the year 2004, and there will be a minimum time lag of 1 year before the predecessor auditor of record can return. Austria does not have a partner rotation requirement; however, anyone who serves as the audit partner of a public company for 6 consecutive years will not be allowed to continue to serve in that capacity by becoming employed by the company's successor auditor.

United Kingdom

In January 2003, the United Kingdom adopted the recommendations of the Co-ordinating Group on Audit and Accounting Issues (CGAA)[3] to strengthen the audit partner rotation requirements by reducing the maximum period for rotation of the lead audit partner from 7 years to 5 years. The United Kingdom also adopted CGAA's recommendation to limit the maximum period for rotation of the other key audit partners to 7 years. According to the CGAA report, the rotation of the audit engagement partner has been a requirement in the United Kingdom for many years, and the United Kingdom concluded that the requirements for the rotation of audit partners played an important role in upholding auditor independence.

With respect to the issue of mandatory audit firm rotation, the United Kingdom supports CGAA's recommendations, which concluded that the balance of advantage is against requiring the mandatory rotation of audit firms. The primary arguments against mandatory audit firm rotation, as cited in the CGAA report, include the possible negative effects on audit quality and effectiveness in the first years following a change, the substantial costs resulting from a requirement to switch auditors regularly, the lack of strong evidence of a positive impact on audit quality, the potential difficulty or impossibility of identifying a willing and able audit firm that can accept the audit without violating independence requirements

[3] The CGAA was established by the Chancellor of the Exchequer and the Secretary of State for Trade and Industry to ensure that there is a coordinated and comprehensive work program for individual regulators to review the United Kingdom's current regulatory arrangements for statutory audit and financial reporting, avoiding any unnecessary overlap; commission additional work or reviews if judged appropriate; and reach a view on the adequacy of the proposals, and, if appropriate, make specific recommendations.

in a concentrated listed company audit market, and competitive implications of such a requirement. However, CGAA also recommended that audit committees should consider changing their auditor of record when the audit tenure is from 15 years to 20 years.

France

In France, audit partner rotation had been required since 1998 by the French Code of Ethics of the accounting profession. However, the requirement was not enforceable because the Code of Ethics had not specified any maximum length for mandatory rotation of audit partners. In August 2003, France promulgated the French Act on Strengthening of Financial Security, which makes it illegal for an audit partner to sign more than six annual audit reports. The main requirement that serves as an alternative to mandatory audit firm rotation is the French requirement of having two firms engaged in the audit of entities issuing consolidated financial statements, which has been a requirement since 1985 and has been reincluded in the August 2003 promulgation of the French Act on Strengthening of Financial Security. According to the Deputy Chief Accountant of the Commission des Operations de Bourse, mandatory audit firm rotation is not required in France primarily because of concern over the potential impairment of audit quality due to the new auditor's lack of knowledge of the company's operations.

Spain

The Comision Nacional del Mercaso de Valores (CNMV)—the agency in charge of supervising and inspecting the Spanish stock markets and the activities of all the participants in those markets—indicated that from 1989 through 1995, Spain had a mandatory audit firm rotation requirement with a maximum audit term of 9 years, which included mandatory retendering every 3 years. The main objectives of this former requirement were to enhance auditors' independence and promotion of fair competition. However, in 1995, the Spanish "Company Law" and the Spanish "Audit Law" were amended, effectively eliminating the mandatory audit firm rotation requirement, by allowing that "after the expiration of the initial period (minimum 3 years, maximum 9 years), the same auditor could be re-hired by the shareholders on an annual basis." The Director of the CNMV indicated that the 9-year mandatory audit firm rotation requirement was abandoned since the main objective of increased competition among audit firms had been achieved and because of listed companies' increased training costs incurred with a complete new team of auditors from a new public accounting firm. In November 2002, the Spanish "Audit Law" was amended to introduce a new requirement under which "all audit-engaged team" members (including audit partners, managers, supervisors, and junior staff) have to rotate every 7 years in certain types of companies, which include all listed companies, companies subject to public supervision, and companies with annual revenues over 30 million euros.

The Netherlands

In January 2003, the Royal Nederlands Instituut van Register Accountants (NIvRA) and Nederlandse Orde van Accountants-Administratieconsulenten (NOvAA) of the Netherlands, which are the bodies that represent the accounting profession in the Netherlands and are responsible for the qualifications and regulation of the accounting profession, adopted the recommendation of CGAA to strengthen the audit partner rotation requirements by reducing the maximum period for rotation of the engagement audit partner from 7 years to 5 years and to limit the maximum period for rotation of the other key audit partners to 7 years. The adoption of these measures by both NIvRA and NOvAA made these requirements a part of the code of conduct for auditors. A representative of the Netherlands Authority for the Financial Markets indicated that the Dutch government is in the process of promulgating these audit partner rotation regulations into law, where the requirement will only apply to public interest entities.

Japan

In Japan, the Amended Certified Public Accountant Law was passed in May 2003, and beginning on April 1, 2004, audit partners and reviewing partners will be prohibited from being engaged in auditing the same listed company over a period of 7 consecutive years. Mandatory audit firm rotation has never been required in Japan, and public companies have never been encouraged to voluntarily pursue audit firm rotation. While Japan agreed with the December 2002 report issued by the Subcommittee on Regulations of Certified Public Accountants of the Financial System Council that mandatory audit firm rotation will need further consideration in the future, Japan's securities regulator stated that mandatory audit firm rotation was not supported because of the concerns that it (1) may cause confusion given the concentration of audit business held by large public accounting firms, (2) is not required in other major countries other than Italy, (3) may significantly lower the quality of audits due to the need to arrange newly organized audits, and (4) would result in greater cost of implementation under the current concentration of audit business held by large public accounting firms.

Canada

There are currently no Canadian requirements for mandatory audit firm rotation. However, mandatory audit firm rotation was included in banking legislation shortly after the 1923 failure of the Home Bank and up to the December 1991 revision of the Bank Act. The Bank Act required that two firms audit a chartered bank, but that the same two firms could not perform more than two consecutive audits. As a result, one of the two firms would have to rotate off the audit for a minimum of 2 years.

According to Canadian officials, in practice this requirement was implemented in two different ways. Some banks appointed a panel of three audit firms with one of the three firms being a permanent auditor while the other two firms rotated every 2 years. Other banks appointed a panel of three audit firms and rotated among the three firms. Generally, the firm that was in its “off year” did not completely step away from the audit of the bank and would maintain at least a watch on developments in the bank’s business and financial reporting to ensure that it was knowledgeable enough to step back in when it rotated on again.

One of the primary benefits of the system was believed to be that the use of two firms facilitated an independent review of the loan portfolio. This new perspective was generally considered to be a useful safeguard, and it was believed that the second firm would not bring with it an element of additional cost. The rotation element of the system was considered to bring with it an additional element of security by ensuring that issues were reviewed regularly by auditors with a fresh perspective, thus minimizing the risk of a problem festering because an issue was decided on and not reevaluated.

Since the 1923 failure of the Home Bank, the dual auditor requirement with mandatory audit firm rotation for one of the two audit firms every 2 years was in place for over 60 years and was considered to be one of the key safeguards in the bank governance system. However, in 1985 two regional banks in the province of Alberta failed despite the existence of the dual auditor system. A subsequent government inquiry into the failures found that the Office of the Inspector General of Banks, now the Office of the Superintendent of Financial Institutions (OSFI), heavily relied on the external auditors and recommended the need for some direct examination by the supervisor of the quality of banks’ loan portfolios. Until 1991, only Canadian banks were required to rotate their auditor of record. In 1991, in line with a push for harmonized supervision, banking legislation was amended to reduce the requirement to one audit firm, and the mandatory audit firm rotation requirement was abandoned with the revision of the

Bank Act. According to Canadian officials, one of the reasons for the abandonment was that many argued that the cost was not matched by the benefits and it was noted that Canada seemed to be largely alone in the world imposing such a system. There were few strong advocates for retaining the system, but questions were raised as to whether it was in fact a valuable element of protecting the safety and soundness of the banking system.

Mandatory audit firm rotation is not currently being considered in Canada. Instead, as of July 2003, mandatory rotation of audit partners for all public companies was being considered by Canada's securities regulator, supported by a new model of independent oversight and inspection of auditors of public companies. The accounting profession, through the Public Interest and Integrity Committee of the Canadian Institute of Chartered Accountants and in collaboration with provincial institutes, is considering developing an updated independence standard that considers certain requirements of the Sarbanes-Oxley Act for Canadian application to listed financial institutions regulated by OSFI. This independence standard will focus on mandatory rotation of the engagement partner rather than the firm auditing a listed enterprise regulated by OSFI, as well as other key members of the firm involved with the audit. According to Canadian officials, extending this requirement to nonlisted financial institutions is under consideration but the outcome will not be known for some time.

Germany

In Germany, according to the German Commercial Code, a qualified auditor or certified accounting firm, beginning with annual financial statements issued after December 31, 2001, may not be an auditor of a stock corporation that has issued officially listed shares if it employs a certified accountant who has signed the certification concerning the examination of the annual financial statements or the consolidated financial statements of the corporation more than six times in the 10 years prior to the fiscal year to be examined. According to German officials, the principle of audit partner rotation has proven to be successful, and there are no plans to switch to a model based on mandatory audit firm rotation because the purpose of guaranteeing an independent audit of the financial statements of a company can be efficiently achieved by audit partner rotation. However, in order to improve investor protection and company integrity, Germany's federal government published a 10-point paper, which included a planned amendment to the corresponding Commercial Code regulations to shorten the period of time after which an auditor of record must rotate to every 5 years and to include all responsible audit partners in the rotation requirement.

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