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Don't Wait for a Crisis: **Rotate Your Auditors**

Vinay Goyal

Problem of Practice: *Have you ever wondered what skeletons are hiding in your organization's closet? Is there a flaw in your incentive structure that encourages employees to hide risks instead of raising them? Have you been with the same auditor, or simply swapping two auditors with similar approaches, for many years now? If your answer is 'yes' to any of these questions, perhaps you should consider opting for a new auditor. Recent research by de Ricquebourg and Maroun[1] suggests that rotating your auditor might bring in some surprises but you will avoid any scandals*

Why auditor rotation matters

Audits are meant to manage risk as they provide an independent and objective evaluation of a company's financial control, risk management, and governance measures. The findings of an audit process are meant to not only provide assurance, but also raise red flags for management to consider and improve on. The International Auditing and Assurance Standards Board is a globalbody that provides guidance to auditors the world over, and one of their standards[2] (ISA 701) in particular, mandates that the auditors need to highlight key audit matters (KAMs) that can help better the current period's financial statements. These KAMs might be considered as red flags by some, but, as the Association of Chartered Certified Accountants[3] argues, ultimately lead to better governance. KAMs can be a wakeup call that prevent larger breaches in risk and governance. So what steps need to be taken to ensure that you are setting up good quality KAMs and not missing any important ones?

Research by de Ricquebourg and Maroun found that a critical element in ensuring quality KAMs —changing your auditor firm — has a significant impact on the KAMs added to or removed from a company's audit report. The implication is that the company is able to get a fresh perspective on their financial well-being by changing their audit firm. Any company director who wants to signal to the market that they have a genuine desire to uncover any irregularities in their financial statements should consider rotating between suitably qualified auditing companies on a regular basis.

[1]Featured in the March 2023 issue of the journal The *British Accounting Review*; authors Alan Duboisée de Ricquebourg and Warren Maroun identified found that rotating audit firms leads to different key audit matters being identified, in their article[4] 'How do auditor rotations affect key audit matters? Archival evidence from South African audits'.

Research by de Ricquebourg and Maroun found that when the company switched auditing firms, the number of new KAMs rose by 31% relative to the base case

There are many cautionary tales that highlight the importance of such a move. Consider the case of Adani Group, the Indian conglomerate, which made headlines the world over when it lost over $100 billion[5] in market valuation over across January and February 2023 due to short-selling. The short seller, Hindenburg Research[6], published a damaging report on the Adani Group[7], highlighting irregularities in the conglomerate's financial statements. A key issue raised in the Adani case was that the same firm had been auditing the group's financial statements for years and some senior member of this audit firm did not seem sufficiently qualified[8] to be auditing a group of Adani's complexity.

In the face of any such scandals relating to financial statements, the independence of the auditing company always comes under a scanner. If the company can show that it has done everything in its power to ensure that its statements are fairly audited and accurate, they will be placed in better stead, regardless of whether those accusations turn out to be accurate or not. Frequently switching between suitably qualified audit firms is a great signal that the company values transparency and take any new issues (KAMs) highlighted by new auditors seriously.

Better auditing to governance

The spotlighted research examined what happened to the number of KAMs with a company (a) keeping the same audit firm and audit partner (b) keeping the same firm but switching the partner, and (c) switching the firm and partner. They found that switching the partner, on average, resulted in a 9% increase in the number of new KAMs relative to the base case of keeping the same firm and partner. What was more surprising was that new KAMs rose by a whopping 31% relative to the base case when the company switched the auditing firm.

The International Auditing and Assurance Standards Board[9] advises that an issue should be highlighted as a KAM if (a) there is a risk of material misstatement, (b) there are significant estimates and judgements involved in the issue, or (c) significant events and transactions relating to the issue have occurred during the reporting period. In other words, KAMs are issues where your company could be in a grey area of accounting regulations or where changes in circumstances may lead to sudden, significant changes in the company's financial position. Human are inherently resistant to change and, hence, there can be cases where the company can present these issues in a positive light. Similarly, your incumbent auditor may have considered these issues in previous years and decided to maintain consistency with previous judgements. However, developments in a year may push the judgement regarding a KAM past the tipping point, where it is no longer appropriate. A new auditor, with a fresh pair of eyes, is more inclined to challenge your company's judgement and encourage you to face up to an issue, thus ensuring that a surprise does not become a shock or a full-blown public scandal.

Even if an issue is not a scandal in the waiting, it is still a risk to be managed appropriately. All major audit companies are, of course, experts in their field. However, they do have slightly different approaches. Hence, changing your auditor is akin to getting a second professional medical opinion on a health issue. Even if you can't confirm either approach or recommendation as the one, correct path to take, having different opinions ensures that your company can take into consideration different accounting and risk management strategies. And this is better than being caught unawares.

KAMs in practice

After ISA 701 was released, in 2019, software giant Microsoft became one of the first American firms to make critical audit matter disclosures[10]. Their auditor, Deloitte, highlighted KAMs relating to (a) their recognition of revenue and (b) uncertain income tax provisions. Both these KAMs enabled the target audience understand why Microsoft stated their financial position the way they did.

But since then, KAM identification and reporting has become a grey area in practice. An interesting example is the 2020 audit report by PriceWaterhouseCoopers[11] for Ferratum Oyj[12], an European consumer lending company. The auditor identified all credit loss allowances in respect of loans and advances to customers as a KAM for Ferratum. However, they identified no such KAM while auditing Multitude SE — Ferratum's parent company. Other auditors could have assessed this situation differently.

The de Ricquebourg and Maroun research was based on data from audit reports of South African companies. Even though their sample included hundreds of companies which were analyzed over multiple years, and by more than a dozen audit firms, these findings need to be corroborated when being applied to a particular location. For instance, survey-based research in Finland found that the introduction of KAMs was perceived to improve audit effectiveness and cooperation between auditors and managers[13], but did not seem to have any material effect on the audit quality.

What seems to be clear from research into actual audits is that the more the KAMs identified during an audit, the better the company's position. So, in practice, switching auditors on a regular basis will lead to different approaches and procedures being applied to your company's audit, leading to a reduction in your firm's risk and governance blind spots. Financial and operational inconsistencies will be brought up on a regular basis and persistent issues will be discovered faster when the auditor is rotated. How often should you rotate your auditor depends on how dynamic and complex your business is. The more complex and dynamic the business, the less period between rotating your auditors.

To conclude, if auditors are frequently rotated, the overall quality of your company's financial statements would increase over time, the likelihood of sudden variations would decrease and the firm would be considered more reliable. Hence switching auditors regularly is a good practice to incorporate as it is an indication of your company's integrity.

Vinay Goyal *is Associate Professor in the department of Finance & Economics at SPJIMR. He also serves as Director of academic operations at SPJIMR.*

You can reach out to him at ***vinay.goyal@spjimr.org***

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Has your company been rotating auditors, or does it stick to a regular few? Do you have some inputs you would like to share? Then you can reach out to us at **mpi@spjimr.org.**

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