AN ANALYSIS OF MANDATORY AUDITOR ROTATION REQUIREMENTS IN SOUTH AFRICA IN LIGHT OF INTERNATIONAL LEGISLATIVE TRENDS

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SUMMARY

An independent and objective external audit of companies is an integral element of sound corporate governance and of functional financial markets. The issues relating to auditor independence and objectivity have attracted considerable regulatory and public scrutiny in many leading jurisdictions. This is partly due to a general decrease in audit quality over the years as evidenced by high-profile accounting scandals and audit failures, both locally and internationally, as well as the vital role that an external audit is expected to play in ensuring transparency, accuracy and efficiency in the financial markets. In an attempt to restore confidence in the audit profession and to strengthen the independence of the external audit function for companies, legislatures in some leading jurisdictions have introduced a variety of regulatory strategies, including mandatory rotation of auditors in the form of mandatory audit partner rotation (MAPR) and/or mandatory audit firm rotation (MAFR). In this article, the author examines the adequacy of the current provisions of section 92 of the Companies Act 71 of 2008 regarding MAPR and the recently promulgated rule of the Independent Regulatory Board for Auditors (IRBA) on MAFR (the MAFR rule) in addressing the issue of mandatory auditor rotation in South Africa. The author considers whether the provisions of the Companies Act 71 of 2008 regarding MAPR and the MAFR rule are adequate to promote an independent and objective external audit function for companies, as well as transparency, efficiency and accountability, while providing certainty for companies and auditors. The author first examines some of the key principles and policy considerations relating to the external audit of companies – namely, the significance of audits and auditors in the financial markets as well as the value of auditor independence and objectivity. This is followed by an examination of the provisions of section 92 of the Companies Act 71 of 2008 regarding MAPR and the recently promulgated MAFR rule in light of legislative developments in the United States, Canada, the European Union, Australia and India regarding mandatory rotation of auditors and audit partners. Based on the lessons to be drawn from the experiences of the above jurisdictions, the author then makes recommendations for appropriate reforms for South Africa in this important area of company law. This is followed by some concluding remarks.

1 INTRODUCTION

The independent and objective external audit of companies is an integral element of sound corporate governance and of functional financial markets. The problems associated with the external audit of companies, such as inaccurate financial reporting owing to lack of auditor independence, have attracted considerable regulatory scrutiny in many leading jurisdictions. This is partly due to a general decrease in audit quality over the years as evidenced by high-profile accounting scandals and audit failures, both locally and internationally.[1] These developments have underscored the need for effective regulatory interventions to ensure, among other things, that sufficient safeguards are in place to promote an independent and objective external audit function for companies as well as to restore public confidence in the auditing profession. Inaccurate financial reporting owing to lack of auditor independence may undermine confidence in the external audit of companies and the value of company audits in future. The other factor that has contributed to increased regulatory and public focus on the external auditor is the vital role that an external audit is expected to play in protecting companies and their stakeholders through ensuring transparency, accuracy and efficiency in the financial markets.[2] Consequently, in an attempt to restore confidence in the audit profession and to strengthen the external audit function for companies, legislatures in some leading jurisdictions have introduced a variety of regulatory strategies, including ones directed at

[1] Globally, accounting scandals and audit failures in large companies played a significant role in the catastrophic global financial crisis of 2008–2009. Spectacular collapses of big companies in the United States and Europe, such as Enron, WorldCom, Global Crossing, Parmalat, Adelphia and Vivendi, were preceded by the revelation of irregularities in financial reporting and the reluctance of auditors to monitor company management on financial matters adequately. South Africa has also witnessed catastrophic corporate collapses, especially between 2000 and 2010. These include Leisurenet, Saambou, UniFer, Rand Gold, Fidentia and Sharemax. See IRBA "Frequently Asked Questions: Strengthening Auditor Independence to Enhance Public Investor Protection through Mandatory Audit Firm Rotation (MAFR)" (9 June 2017) https://www.irba.co.za/upload/FAQ%20MAFR%209%20June%202017.pdf 5 (accessed 2017-09-24). Furthermore, the recent collapse of companies such as African Bank Investments Holdings Limited, VBS Mutual Bank and Steinhoff International NV, as well as the controversial audits by audit firm KPMG of the Gupta family companies, such as Linkway Trading (Pty) Ltd. and the South African Revenue Services (SARS) Report have brought auditors and the audit profession under increased scrutiny in South Africa. See, for eg, Davis, Geach, Mongalo, Butler, Loubser, Coetzee and Burdette *Companies and Other Business Structures in South Africa* 4ed (2019) 307; IRBA "Update on IRBA Investigations Into KPMG" (12 January 2018) https://www.irba.co.za/news-headlines/press-releases/update-on-irba-investigations-into-kpmg (accessed 2018-09-22); Parliament of the Republic of South Africa "Standing Committee on Finance to Receive Report From IRBA on KPMG and Deloitte Investigations" (18 September 2017) https://www.parliament.gov.za/press-releases/standing-committee-finance-receive-report-irba-kpmg-and-deloitte-investigations (accessed 2017-09-22); South African Reserve Bank "VBS Mutual Bank Investigators Report to the Prudential Authority" (10 October 2018) https://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4 &sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=8830 (accessed 2018-10-30); Ziady "Audit Regulator Sinks its Teeth into its Biggest Case, Deloitte's Abil Audit" (20 March 2018) https://www.businesslive.co.za/bd/companies/financial-services/2018-03-20-public-disciplinary-hearings-on-deloittes-african-bank-audit-start/ (accessed 2018-03-30).

[2] See Davis, Geach, Mongalo, Butler, Loubser, Coetzee and Burdette *Companies and Other Business Structures in South Africa* 4ed (2019) 306-307.

addressing auditor independence. One strategy introduced to strengthen auditor independence is mandatory auditor rotation in the form of mandatory audit partner rotation (MAPR) and/or mandatory audit firm rotation (MAFR).[3]

In this article, the author examines the adequacy and efficacy of the current provisions of section 92 of the Companies Act[4] regarding MAPR and the recently promulgated rule of the Independent Regulatory Board for Auditors (IRBA) on MAFR (MAFR rule) in addressing auditor independence in South Africa. The author considers whether the provisions of the Companies Act regarding MAPR and the MAFR rule are adequate to promote an independent and objective external audit function for companies as well as transparency, efficiency and accountability while providing certainty for companies and auditors.

The author first examines some of the key principles and policy considerations relating to the external audit of companies – namely, the importance of audits and auditors in financial markets as well as the value of auditor independence and objectivity. This is followed by an examination of the provisions of section 92 of the Companies Act and the recently promulgated MAFR rule in light of legislative developments in the United States (US), Canada, the European Union (EU), Australia and India regarding mandatory rotation of auditors and audit partners. The author then makes recommendations for appropriate reforms for South Africa in this important area of company law, based on the lessons that may be drawn from the experiences of the above jurisdictions. This is followed by some concluding remarks.

One reason for selecting the US, Canada, Australia and India for comparison is that these jurisdictions come from the same legal family as South Africa.[5] A comparative study of this nature also makes sense in view of the influence of foreign company law (particularly English, Australian and American company law) in the reform of South Africa's company law, which culminated in the enactment of the current Companies Act.[6] There have been important developments in these jurisdictions, including in the EU, that are relevant to the topic – namely, high-profile audit failures and regulatory efforts in response to these failures that have brought the problematic issues associated with the external audit of companies (including lack of auditor independence) to the fore. The selected international jurisdictions have therefore introduced specific statutory reforms regarding auditor and/or audit

[3] Other strategies introduced to regulate the perceived problematic issues associated with the external audit of companies generally include the strengthening of the rules governing the provision of non-audit services to audit clients, the role and responsibilities of auditors, auditor oversight, auditor liability and audit committees.

[4] 71 of 2008.

[5] The company law rules that have developed in South Africa have a common heritage with English, American and Australian law.

[6] 71 of 2008. For eg, the UK Companies Act 2006 and the Australian Corporations Act 2001 significantly influenced the provisions of Act 71 of 2008. See, in this regard, Du Plessis and Mathiopoulos "Defences and Relief from Liability for Company Directors: Widening Protection to Stimulate Innovation" 2016 *Aust Jnl of Corp Law* 287 305. The Department of Trade and Industry (DTI) Policy Paper of 2004 expressly stated that it was essential for South African company law to be harmonised with the company laws of international jurisdictions, where appropriate, in view of the involvement of South Africa and international jurisdictions in international trade and investment.

partner rotation in order to address the identified problematic issues related to auditor independence. Another important motivation for a comparative analysis is that company audits are a global phenomenon, in at least three ways. First, it cannot be overemphasised that companies, especially multinational companies, are global entities.[7] The second factor is that companies – whether multinational or not – raise capital both within their home markets and abroad.[8] Thirdly, the network of audit firms is in fact highly globalised,[9] giving rise to the need for adequate and harmonised regulation.

2 THE SIGNIFICANCE OF AN EXTERNAL AUDIT IN THE CAPITAL MARKETS

The Companies Act[10] – the main piece of legislation regulating companies in South Africa – contains important provisions regarding the external audit of a company's financial statements. It requires every public company, every state-owned company and certain categories of private company to appoint an external auditor to examine their annual financial statements in accordance with prescribed laws or applicable auditing standards.[11]

Part C of Chapter 2 of the Companies Act contains important provisions that give the primary role to company directors as far as the detailed preparation and approval of a company's financial statements is

[7] Doty "The Relevance, Role, and Reliability of Audits in the Global Economy" 2012 90 *Texas LR* 1891 1907.

[8] Doty 2012 *Texas LR* 1907.

[9] For eg, the IRBA has observed that each of the global audit firms such as Deloitte, Ernst & Young, KPMG, PwC, BDO and PKF have offices/operations in more than 150 countries while audit firms like Grant Thornton, RSM, Howarth Leveton Boner and Nexia SAB & T have offices/operations in over 120 countries. See IRBA https://www.irba.co.za/upload/FAQ_%20MAFR%209%20June%202017.pdf (accessed 2017-09-24).

[10] 71 of 2008.

[11] See s 90(1) and (1A) as read with ss 34(2) and 84(1)(*c*)(i)–(ii). Apart from public companies and state-owned companies, the annual financial statements of any other profit or non-profit company must be audited if so required by the regulations made by the Minister in terms of s 30(7), taking into account whether it is desirable in the public interest, having regard to the economic or social significance of the company, as indicated by any relevant factors, including the company's annual turnover, the size of its workforce, or the nature and extent of its activities. See s 30(2)(*b*)(i). In terms of reg. 28(2) of the Companies Regulations, 2011, in addition to public companies and state-owned companies, any company that falls into the following categories in any financial year must have its annual financial statements for that financial year audited: any profit or non-profit company if, in the ordinary course of its primary activities, it holds assets in a fiduciary capacity for persons who are not related to the company and the aggregate value of such assets held at any time during the financial year exceeds R5 million; any non-profit company if (i) it was incorporated directly or indirectly by the state, an organ of state, a state-owned company, an international entity, a foreign state entity or a foreign company, or (ii) it was incorporated primarily to perform a statutory or regulatory function in terms of any legislation, or to carry out a public function at the direct or indirect initiation or direction of an organ of the state, a state-owned company, an international entity, or a foreign state entity, or for a purpose ancillary to any such function; and any other company whose public interest score in that financial year is 350 or more, or is at least 100, if its annual financial statements were internally compiled. A company's annual financial statements must also be audited voluntarily if the Memorandum of Incorporation of that company or a shareholders' resolution so requires, or if the company's board of directors has so determined. See s 30(2)(*b*)(ii)(*aa*) of Act 71 of 2008.

concerned.[12] Notably, section 29(1)(*b*) requires that a company's financial statements – including annual financial statements – must *inter alia* present fairly the company's state of affairs and its business, and must also explain the company's transactions as well as the financial position of the company's business. These financial statements must show the company's assets, liabilities and equity (the balance sheet), the company's income and expenses (the statement of income) and any other prescribed information.[13] The annual financial statements must also include an audit report (if they have been audited) and a directors' report regarding the state of affairs, business, and loss or profit of the company or group, as the case may be.[14] Importantly, the statements must not be incomplete, false or misleading in any material respects.[15]

Chapter 3 of the Companies Act then gives the external auditor the secondary role – to audit a company's annual financial statements. The objective of auditing a company's financial statements is to allow the external auditor to express an expert opinion on the fairness of the financial statements or on their adherence to an identified financial reporting framework and the relevant statutory requirements.[16] In addition to the requirements on the preparation, approval and auditing of annual financial statements, the Companies Act provides for the presentation of a company's annual financial statements at shareholders' meetings.[17] In addition, the Companies Act requires every company that must have its annual financial statements audited in terms of the Companies Act to include a copy of its annual financial statements in an annual return that must be filed with the Companies and Intellectual Property Commission (CIPC).[18] Importantly, the CIPC must make such information "efficiently" and "effectively" available to the public as required by section 187(4)(*c*). These requirements ensure that a company's audited annual financial statements are made available to the company's shareholders as well as to members of the public. It is therefore critical to understand the economic value of external audits, not only for companies and their shareholders, but for various company stakeholders or participants in the financial markets, including the general public.

Broadly, a positive audit opinion, as to the fairness of financial statements and their compliance with applicable financial reporting standards and statutory requirements, is valuable in that it gives credibility and reliability to the financial statements. By giving credibility and reliability to financial information, the external auditor performs an essential role in protecting

[12] See, generally, s 24–34 of Act 71 of 2008.

[13] S 29(1)(*c*) of Act 71 of 2008.

[14] The directors' report should include any matter that is relevant for shareholders to understand the company's state of affairs. The report must also include any prescribed information. See s 30(3)(*b*) of Act 71 of 2008.

[15] S 29(2) of Act 71 of 2008.

[16] See the meaning of "audit' in s 1 of Act 26 of 2005.

[17] See s 30(3)(*d*) of Act 71 of 2008, which requires that the annual financial statements be presented to the first meeting of the shareholders following the approval of such statements by the board. See also s 61(8)(*a*)(ii), which stipulates that the annual general meeting of a public company must provide for the presentation of audited financial statements for the immediately preceding financial year.

[18] See s 33(1)(*a*) of Act 71 of 2008.

existing shareholders, companies, prospective investors, the financial markets and various other participants in such markets. This is discussed further below.

2 1 Protection of existing shareholders

Auditors have been described as "watchdogs" owing to their role of watching over company directors on behalf of shareholders. This dates from the inception of modern auditing in the Joint Stock Companies Act of 1844 and the Companies Clauses Act of 1845 in the UK.[19] This role has traditionally involved the examination of financial statements with the objective of checking inaccurate financial reporting – namely, fraud or material errors in financial reporting by companies.[20] It is noteworthy that inaccurate financial reporting by company management may be symptomatic of weaknesses associated with the principal-agent relationship in the management of companies. This is so because financial reporting is one of the areas where there is a high possibility of conflict between the interests of company management and those of shareholders.[21] In the absence of sound corporate governance, there is the possibility that company management may falsify a company's financial information for a variety of self-serving ends. These self-serving ends may include boosting management's performance-based remuneration incentives, covering up fraud and obscuring poor-quality investment decisions or strategies taken by company management.[22] In view of this, an external audit ideally serves as an essential component of corporate governance as it makes the board of directors transparent and accountable to shareholders concerning its stewardship of the company's assets.

The role of auditors in protecting company shareholders has been acknowledged in case-law authorities in common-law jurisdictions such as the UK[23] and South Africa.[24] For example, in *Caparo Industries plc v*

[19] See O'Connor "Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence" 2004 45 *Boston College LR* 741 749–775. Christiansen and Olazabal "Auditor Independence Post Sarbanes-Oxley: The Case for Increased Self-Regulation" 2007 13 *Journal of Legal Studies in Business* 69 71.

[20] Kandemir "Auditing Versus Consultancy: A Critique of the EU Law Reforms on the New Form of Auditing" 2016 5 *Journal of Governance and Regulation* 90 91.

[21] Acemoglu and Gietzmann "Auditor Independence, Incomplete Contracts and the Role of Legal Liability" 1997 6 *The European Accounting Review* 355 355–356.

[22] Doty 2012 *Texas LR* 1894. See also Cullen *Executive Compensation in Imperfect Financial Markets* (2014) 185; Markham "Regulating Excessive Executive Compensation – Why bother?" 2007 2(2) *Journal of Business and Technology* 277 296–298; Fried and Shilon "Excess-Pay Clawbacks" 2011 36(4) *The Journal of Corporation Law* 727–728.

[23] In regard to case law in the UK, see *Re London and General Bank* (No 2) [1895–9] All ER 953 (CA); *Re Kingston Cotton Mill Co* [1896] 1 Ch 6 (CA); and *Caparo Industries plc v Dickman* [1989] 1 All ER 798; *Caparo Industries plc v Dickman* [1990] 1 All ER 568. In *Re London and General Bank*, the court held that the role of the auditor is to ensure that company shareholders receive reliable information regarding the financial affairs of the company and, consequently, their investments in the company. In *Re Kingston Cotton Mill Co*, the court held that the auditor is appointed by company shareholders to be a check upon the directors and that the auditor must exercise his functions with reasonable care and skill.

[24] An instructive South African case in this regard is *Powertech Industries Ltd v Mayberry* 1996 (2) All SA 561 (W).

Dickman,[25] Lord Bridge of Harwick in the House of Lords held that the statutory provisions regarding the appointment of an auditor to audit a public limited company's accounts created a relationship between the auditor and the company's shareholders "on which the shareholder is entitled to rely for the protection of his interest." This view buttressed Bingham LJ's earlier assertion in the Court of Appeal that the auditor was hired by the company to "exercise his professional skill and judgment for the purpose of giving the shareholders an independent report on the reliability of the company's accounts and thus on their investment."[26] Similarly, in the South African case of *Powertech Industries Ltd v Mayberry*,[27] the court held that even though the auditor was hired and compensated by the company, he must perform the "independent" role of "reporting to shareholders" on the company's financial statements that have been drawn up and presented by the directors. As such, the court held, the auditor owed a duty to individual shareholders to exercise his functions as auditor of the company with reasonable skill and care.

The auditor's report on the company's financial statements provides shareholders with reliable information on which to base decisions regarding the exercise of their governance functions in the company. Under the Companies Act,[28] shareholders' governance functions may be exercised in a variety of ways, including voting on various resolutions proposed at shareholders' meetings. Such resolutions may relate to the election or re-election of the directors, approval or disapproval of a repurchase of the company's issued shares, remuneration of directors, issue of the company's unissued shares as well as the approval or disapproval of corporate actions such as disposals of assets or undertakings, amalgamations or mergers, or schemes of arrangement. Shareholders' governance functions may further be exercised through direct engagement with the board of directors on its conduct of the business and affairs of the company. The company's general meetings typically provide a platform for shareholders to express their concerns in relation to various issues affecting their rights and interests in the company. In *Caparo Industries plc v Dickman*,[29] the court held that shareholders cannot be expected to exercise their governance functions in a company on the basis only of the information that company management elects to provide them.

In addition to empowering shareholders to monitor company management, the auditor's report enables shareholders to monitor their investments in the company effectively. For example, it enables shareholders to make informed decisions on whether they should maintain their shareholding in the company or whether they should sell their shares in the company as well as whether they should subscribe for additional shares in the company.[30] The availability of necessary and accurate financial

[25] [1990] 1 All ER 568.

[26] See *Caparo Industries plc v Dickman* [1989] 1 All ER 798 804.

[27] *Supra*.

[28] Act 71 of 2008.

[29] *Caparo Industries plc v Dickman* [1989] 1 All ER 798 805.

[30] See *Caparo Industries plc v Dickman* [1989] 1 All ER 798 804.

information is essential for shareholder decision-making and monitoring mechanisms to be effective.

An independent and objective external audit may thus reinforce transparency and high standards of corporate governance as envisaged in section 7(*b*)(iii) of the Companies Act by promoting accurate financial reporting, aligning the interests of company management with those of shareholders and reducing the principal-agent problem within companies.[31] This would also be in line with section 7(*j*), which lists encouraging the efficient and responsible management of companies as one of the purposes of the Companies Act. It may make it possible for shareholders to monitor the strategies adopted by company management effectively. It may also serve as deterrence to weak corporate governance practices such as self-dealing, lack of transparency and financial reporting frauds by company management and, as such, may promote the efficient and responsible management of companies as envisaged in section 7(*j*) of the Companies Act.

The difficulty is that the introduction of an auditor as a third party to mitigate the principal-agent problem between company shareholders and management creates yet another problematic principal-agent relationship between company management and the auditor.[32] This is because, as discussed below, the auditor is hired, remunerated and can be dismissed by, company management. The auditor also works closely with company management during the course of conducting the audit and considers the company to be his client.[33]

[31] Acemoglu and Gietzmann 1997 *The European Accounting Review* 356; and Ncube "Transparency and Accountability Under the New Company Law" 2010 *Acta Juridica* 43 60. See also *Caparo Industries Plc v Dickman* [1989] 1 All ER 798 804, where Bingham LJ stated the following:

"At the heart of this case lies the role of the statutory auditor. That role is, I think, without close analogy. Its peculiar characteristics derive from the nature of the public limited liability company. The members, or shareholders, of the company are its owners. But they are too numerous, and in most cases too unskilled, to undertake the day-to-day management of that which they own. So responsibility for day-to-day management of the company is delegated to directors. The shareholders, despite their overall powers of control, are in most companies for most of the time investors and little more. But it would, of course, be unsatisfactory and open to abuse if the shareholders received no report on the financial stewardship of their investment save from those to whom the stewardship had been entrusted. So provision is made for the company in general meeting to appoint an auditor … whose duty is to investigate and form an opinion on the adequacy of the company's accounting records and returns and the correspondence between the company's accounting records and returns and its accounts ... The auditor has then to report to the company's members (among other things) whether in his opinion the company's accounts give a true and fair view of the company's financial position … But he is employed by the company to exercise his professional skill and judgment for the purpose of giving the shareholders an independent report on the reliability of the company's accounts and thus on their investment."

On appeal in the House of Lords, Lord Bridge of Harwick held that the above statement of Bingham LJ accurately summarised the position of the external auditor in relation to shareholders of a public company. See *Caparo Industries plc v Dickman* [1990] 1 All ER 568.

[32] Acemoglu and Gietzmann 1997 *The European Accounting Review* 356.

[33] Bingham LJ in *Caparo Industries plc v Dickman* [1989] 1 All ER 798 804.

2 2 Protection of companies

It has been asserted that one of the primary functions of the statutory auditor is to protect the company by ensuring, as far as possible, the accuracy of financial information that has been prepared by its directors.[34] Accurate financial information, in this regard, protects the company from losses that may result from undetected errors as well as losses that may result from mismanagement or wrongdoing such as misappropriation of the company's funds and fraud by the directors. It has also been pointed out that the auditing process may benefit the company by signaling to the board of directors any "potential sources of future problems".[35] In addition, a favourable audit opinion benefits the company by reducing the costs of attracting capital.[36] This is so because prospective investors presumably have confidence in a company's financial position as well as in the competence of its management if the company has received a positive audit opinion.

2 3 Protection of prospective investors

One of the vital roles that external audits play in both local and global markets is to protect prospective investors and, therefore, promote investment and efficient allocation of capital resources.[37] The provision of timely and reliable information regarding the financial performance and state of affairs of companies enables investors to make their investment decisions in an informed manner. It may also boost investor confidence and encourage investors to invest in particular capital markets or companies. Arguably, this is the most powerful commercial consideration underpinning the statutory provisions that require the publication of a company's audited financial statements and that give members of the public the right to access and inspect these statements.[38]

Investment is critical to economic growth. Economic growth, in turn, creates more employment opportunities, accumulation of capital, further investment and wealth.[39] Interestingly, section 7(*c*) lists the promotion of investment in the South African markets as one of the purposes of the Companies Act. This signifies recognition by the legislature that investment

[34] See Lord Oliver of Aylmerton's concurring judgment in *Caparo Industries plc v Dickman* [1990] 1 All ER 568.

[35] Green "Whither and Whether Auditor Independence" 2008/09 44 *Gonzaga LR* 365 393.

[36] See s 7(*g*) of Act 71 of 2008, which provides that one of the purposes of this Act is to "create optimum conditions for the aggregation of capital for productive purposes, and for the investment of that capital in enterprises".

[37] Doty 2012 *Texas LR* 1893.

[38] See s 187(4)(*c*) as read with s 33(1)(*a*) of Act 71 of 2008. These requirements ensure that credible information about the company's financial performance and state of affairs is generally available to, and accessible by, the investing public. Note, however, that in *Caparo Industries plc v Dickman* [1990] 1 All ER 568, the majority in the House of Lords held that the primary intention of the legislature in enacting provisions regarding the external audit of a company's accounts was to protect the company and its shareholders. The majority made it clear that the protection of the general public and prospective investors is secondary.

[39] Dotty 2012 *Texas LR* 1893.

– both domestic and foreign – is of cardinal importance to South Africa. This is of particular significance since South Africa is a developing country with low levels of economic growth juxtaposed with high levels of unemployment, poverty and inequality. There are, therefore, strong economic and social considerations in favour of statutory mechanisms designed to promote investment in South Africa. It is submitted that an independent and robust external audit function for companies would be one such statutory mechanism. In contrast, inaccurate financial reporting may damage investor confidence in the market and may lead investors to invest less money or to withdraw their investments from a particular market. This may have damaging impacts on the market, such as economic meltdown, rising unemployment, poverty and social unrest.[40]

2 4 Protection of various company stakeholders and financial markets in general

In addition to serving a protective role to companies, shareholders and prospective investors, an external audit may be viewed as an important tool for better decision making by various participants in the capital markets. Audited financial statements (and public disclosure of these statements) may contribute to transparency in the markets by reducing or eliminating the problem of inaccurate financial reporting and speculation. In addition to companies, shareholders and investors, participants in the financial markets include directors, creditors, trade unions, employees, credit rating agencies and regulators. It has been observed that regulators, for example, pay particular attention to the availability of adequate, timeous, reliable and accessible financial information in order to determine whether the financial markets are efficient.[41] Audited financial statements further enable regulatory bodies and stock exchanges to exercise an effective supervisory role over companies and markets. They also enable third parties, such as banks and other lenders, creditors, trade unions, employees, litigants, suppliers, clients or other contracting parties, to make informed judgements regarding their transactions or relationships with the company.

The prevention or elimination of the problem of inaccurate financial reporting by companies is of particular significance in view of the principal-agent problem in the management of companies as well as the contemporary remuneration structures that place more emphasis on the payment of bonuses and other performance-based incentives to company directors and executives.[42] There is a danger that company directors and executives will overstate or manipulate a company's financial information in

[40] In a statement released on 3 April 2014, the European Commission acknowledged that statutory auditors and auditors play a vital "societal role" by providing investors (and shareholders) with an opinion on the accuracy of a company's financial information. See European Commission Statement "European Parliament Backs Commission Proposals on New Rules to Improve the Quality of Statutory Audit" (3 April 2014) http://europa.eu/rapid/press-release_STATEMENT-14-104_en.htm (accessed 2017-09-22).

[41] Kandemir 2016 *Journal of Governance and Regulation* 92.

[42] For a discussion of South Africa's prevalent director and executive remuneration structures, in this regard, see Massie, Collier and Crotty *Executive Salaries in South Africa: Who Should Have a Say on Pay?* (2014) 31–33.

order to increase their performance-based incentives.[43] Apart from seeking to boost their performance-based remuneration incentives, company management may falsify the company's financial performance or information for a variety of other reasons – for example, to avoid liquidation and loss of jobs, or to boost confidence in the company's financial performance by various other stakeholders, such as shareholders, creditors, prospective investors, prospective lenders and regulators. An effective external audit, in such context, helps to prevent a deliberate manipulation of financial information or concealment of material financial information by company management for self-serving imperatives or other motivations. It contributes to fairness and transparency in the financial markets. Consequently, external auditors are frequently viewed as the "gatekeepers" of financial markets[44] and as performing a "public watchdog" function.[45]

To conclude the analysis on the significance of auditing, management may manipulate or falsify a company's financial information to the financial markets for a variety of reasons. This may be further compounded by the principal-agent problem in the management of companies. An external auditor's positive opinion on a company's financial statements – that the statements present fairly, in all material respects, the company's financial position in accordance with the relevant financial reporting standards and the requirements of the relevant statutory provisions – therefore gives credibility to the information contained in such statements and, consequently, to the company's management.[46] The outcome is that audited financial statements are considered to be more valuable and dependable by a variety of company stakeholders. This is so particularly because an external auditor is expected to be more rigorous, independent and objective when examining a company's financial information. It is, however, essential to underscore that a rigorous, independent and objective external audit does not guarantee that the annual financial statements will be completely free of errors. Rather, it simply eliminates the likelihood of material errors in the financial statements.[47] Such audit is considered to be valuable as it is expected to reduce the risk of inaccuracies, omissions, misstatements and fraud in the financial statements.[48]

[43] Doty 2012 *Texas LR* 1894. See also Cullen *Executive Compensation in Imperfect Financial Markets* 185; Markham 2007 2(2) *Journal of Business and Technology* 277 296–298; Fried and Shilon 2011 36(4) *The Journal of Corporation Law* 727–728.

[44] Birke "The Toothless Watchdog: Corporate Fraud and the Independent Audit: How Can the Public's Confidence Be Restored?" 2004 58 *University of Miami LR* 891 895.

[45] See *United States v Arthur Young and Co* 465 U.S. 805 (1984) 817–818. See also European Parliament Resolution of 13 September 2011 on Audit Policy: Lessons From the Crisis (2011/2037(INI)) http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P7-TA-2011-0359+0+DOC+PDF+V0//EN (accessed 2017-09-22), in which the European Parliament expressed the view that "auditing has a social function and is in the public interest". It further noted that an audit constitutes an "absolutely fundamental component of the democratic economic and political system".

[46] Paton "Rethinking the Role of the Auditor: Resolving the Audit/Tax Services Debate" 2006 32 *Queen's LJ* 135 136; Spell "Capping Auditor Liability: Unsuitable Fiscal Policy in Our Current Financial Crisis" 2010 4(2) *Brooklyn Journal of Corporate, Financial and Commercial Law* 323 325–328.

[47] Spell 2010 *Brooklyn Journal of Corporate, Financial and Commercial Law* 325–328.

[48] *Ibid*.

It is submitted that external auditors will continue to play a vital economic role to the audited company as well as a vital economic and social role to various company stakeholders, including the financial markets, by limiting the scope for inaccurate financial reporting by company management. It has, however, been noted that the external audit is of less direct benefit to the company itself than it is to stakeholders such as the investing public and the financial markets.[49] Various participants in the financial markets make important decisions based on the auditor's opinion on a company's financial statements. An external audit arguably has the same value for a company's existing shareholders as it has for prospective investors. Accordingly, external auditors have frequently been viewed as performing a public function and as gatekeepers of the financial markets.[50]

3 SIGNIFICANCE OF AUDITOR INDEPENDENCE

Auditor independence is viewed as an important tool for preventing audit failures and for ensuring an effective external audit of companies. One of the main causes of audit failure (that is, failure by an auditor to reflect a material error in the financial statements in the audit report or a material error in the conduct of the audit) is a material error by the auditor in exercising professional judgement.[51] Serious misjudgement may result from factors such as fraud, but also from lack of auditor independence.[52]

Auditor independence consists of two vital elements. The first is independence of mind (actual independence). The second is independence in appearance. The International Federation of Accountants (IFAC) has defined independence of mind as "the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional scepticism."[53] Thus, independence of mind is the actual state of mind – the existence of objectivity or lack thereof. Independence in appearance has been defined as "the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's or a member of the audit team's, integrity, objectivity or professional skepticism has been compromised".[54] This second element of auditor independence relates to an impression of objectivity or lack thereof – it is the view of a reasonable person on whether or not the auditor is independent that matters. Whereas

[49] See Christiansen and Olazabal 2007 *Journal of Legal Studies in Business* 69; Panttaja "Accountants' Duty to Third Parties: A Search for a Fair Doctrine of Liability" 1994 23 *Stetson LR* 927 932; Green 2008/09 *Gonzaga LR* 393.

[50] Auditors are generally viewed as having a public duty apart from the duty they owe to their clients (ie the audited company). See Christiansen and Olazabal 2007 *Journal of Legal Studies in Business* 69.

[51] Tackett, Wolf and Claypool "Sarbanes-Oxley and Audit Failure: A Critical Examination" 2004 19 *Managerial Auditing Journal* 340 341.

[52] *Ibid*. The other factor that may lead to serious professional misjudgements by auditors is professional incompetence. A discussion of the issue of professional incompetence is beyond the scope of this article.

[53] IFAC Code of Professional Conduct for Registered Auditors (2009) 53.

[54] *Ibid*.

the significance of the first element of auditor independence lies in its direct bearing on audit quality, the importance of the second element (that the audit process be seen to be independent by the end users of audited financial statements) lies in the credibility and reliability to be attached to such financial statements.[55] It is therefore submitted that any audit regulations should pay attention to both elements of auditor independence as they are both important. However, it is further submitted that due care should be exercised not to overemphasise a form-over-substance approach to independence as merely promoting the appearance of auditor independence without promoting actual independence would not contribute to accurate financial reporting, audit quality and the protective role that external audits are expected to play in the financial markets.

There exist formidable impediments to the independence and objectivity of the external auditor owing to a variety of factors. Scholars have reiterated that the problem of a lack of auditor independence is inherent in the modern mandatory annual audit system for companies that were introduced by the federal securities laws of the 1930s in the US.[56] One of the major flaws of this system, which has been adopted in most modern jurisdictions including South Africa, is that external auditors are hired, paid fees for their services and removed by the company.[57] In these circumstances, it has been pointed out that the audited company naturally becomes the auditor's *de facto* client.[58] The independence, objectivity and effectiveness of the auditor in monitoring company management is, therefore, compromised.[59]

In addition to the fundamental structural weakness in the appointment, remuneration and removal of the external auditor as well as in the relationship between the auditor and the company, auditor independence (both actual independence and independence in appearance) may further be impaired by *inter alia* extended auditor tenure.[60] Extended auditor tenure

[55] Tackett, Wolf and Claypool 2004 *Managerial Auditing Journal* 342.

[56] O'Connor 2004 *Boston College LR* 822; Allen and Siegel "Threats and Safeguards in the Determination of Auditor Independence" 2002 80 *Washington University Law Quarterly* 519 523.

[57] Kandemir 2016 *Journal of Governance and Regulation* 92; Doty 2012 *Texas LR* 1895.

[58] O'Connor 2004 *Boston College LR* 824. The appointment of the auditor by the directors under Act 71 of 2008 constitutes an inherent conflict of interests as the auditor is required to examine the financial information that has been prepared and certified by the very same company management to whom the auditor is answerable. See s 90(1) as read with subsections (1A) and (3) of Act 71 of 2008.

[59] See Doty 2012 *Texas LR* 1895. The possibility of collusion between the auditor and company management is high, especially in view of the deep statutory entrenchment of directors' powers of managing and directing the business and affairs of a company in s 66(1) of Act 71 of 2008.

[60] The literature indicates that the various other factors that may potentially impair the auditor's independence and objectivity include auditors' provision of various non-audit services to the companies they audit, employment of senior staff from the external auditor by the audited company, provision of loans or security by the audited company to the auditor, litigation or threat of litigation between the auditor and the audited client, high audit fees, overdue audit fees, gifts or hospitality from the audited client, the existence of certain commercial, family or personal relationships between the auditor and the audited company, and basing the remuneration of the audit partner on the successful marketing of non-audit services to the audit company. See generally Allen and Siegel 2002 *Washington University Law Quarterly* 521; Stewart "Auditing as a Public Good and the Regulation of Auditing" 2006 6 *Journal of Corporate Law Studies* 329 332 and 337; Green 2008/09 *Gonzaga LR* 375–394;

results from lack of rotation in audit firm or audit partner. Such a situation may lead to auditor entrenchment and over-familiarity with the audited company, and may exert undue pressure on the auditor to maintain a long relationship with the audited company.[61]

Considering that international and local audit failures have already highlighted the dangers of inaccurate financial reporting (including corporate collapses with severe effects on the financial markets, employees and societies), appropriate regulation of auditor independence is necessary and desirable in the South African context. It is essential, in this regard, that the law should seek to provide for sufficient safeguards to ensure auditor independence and transparency. Accordingly, the philosophical rationale for MAPR and MAFR as strategies for strengthening auditor independence would be welcome under South African company law.

4 MANDATORY AUDITOR ROTATION IN COMPARABLE JURISDICTIONS

4 1 The United States

The law in the United States (US) provides for mandatory auditor rotation in the form of MAPR but not MAFR. Section 203 of the Sarbanes Oxley Act of 2002 introduced MAPR as one of the strategies for enhancing auditor independence following the high-profile accounting frauds and audit failures in the US. This section amended section 10A of the Securities Exchange Act of 1934 by inserting a new paragraph (j), which provides as follows:

> "It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer."

The effect of section 10A(*j*) of the Securities Exchange Act of 1934 is that the lead audit partner, or the audit partner responsible for reviewing the audit, of an issuer (company) must rotate every five fiscal years of that issuer. There is nothing in the section to indicate that the five-year tenure period may be extended.

It is, however, submitted that section 10A(*j*) of the Securities Exchange Act of 1934 has uncertainties. For example, it is silent on the cooling-off period, namely the period that must first expire before the same lead audit partner may be re-appointed to audit the company. Furthermore, the provision does not specifically address the situation where there is a break in the lead audit partner's tenure before the expiry of the stipulated maximum

Christiansen and Olazabal 2007 *Journal of Legal Studies in Business* 69; Kandemir 2016 *Journal of Governance and Regulation* 93; Cusholi, Chambers and Payne "Future Nonaudit Service Fees and Audit Quality" 2014 31 *Contemporary Accounting Research* 681 681–683; and Paton 2006 *Queen's LJ* 135 140.

[61] Stewart 2006 *Journal of Corporate Law Studies* 332; Garcia-Blandon and Argiles "Audit Firm Tenure and Independence: A Comprehensive Investigation of Audit Qualifications in Spain" 2015 24 *Journal of International Accounting, Auditing and Taxation* 82 91.

tenure period of five fiscal years. It is not clear whether such an interruption in the lead auditor's tenure would be regarded as rotation and whether there should be any cooling-off period that must lapse before that same individual can be re-appointed as lead auditor for the same company.

There is no requirement that the accounting firm itself must rotate in the US. In the absence of MAFR, it is doubtful that MAPR alone can adequately address the problematic issue of lack of auditor independence due to auditor entrenchment, over-familiarity with the audited client and undue pressure on the auditor to maintain a long-standing relationship with the client company. Buttressing the view that MAPR alone may not be enough, some scholars have already pointed out that loyalty to the client company would be equally important to all the audit partners within the audit firm.[62]

However, it is interesting to note that on 16 August 2011 the Public Company Accounting Oversight Board (PCAOB) proposed the introduction of MAFR in the US for public companies as one way to enhance auditor independence, objectivity and professional scepticism.[63] While supporting the PCAOB's objective of enhancing auditor independence, objectivity and professional scepticism, some stakeholders opposed the proposal on the grounds that MAFR would be costly and disruptive.[64] Those who opposed the PCAOB's proposal argued that MAFR would undermine audit quality, institutional knowledge, industry specialisation as well as the audit committee's role of choosing the most qualified audit firm to audit the company.[65] It was further argued that the already-existing MAPR rules were sufficient to ensure auditor independence and objectivity.[66] In response to the PCAOB proposal on MAFR, US Congress passed a Bill known as the Audit Integrity and Job Protection Act, amending section 103 of the Sarbanes-Oxley Act of 2002 to prohibit the PCAOB from introducing MAFR in the US and also requiring the Government Accountability Office (GAO) to update its November 2003 study on the potential effects of MAFR,[67] and to

[62] Ncube 2010 *Acta Juridica* 63.

[63] See Public Company Accounting Oversight Board "Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Release No. 2011–006; and Notice of Roundtable, PCAOB Rulemaking Docket Matter No. 37" (August 16, 2011) https://pcaobus.org//Rulemaking/Docket037/Release_2011-006.pdf (accessed 2017-09-22). It is interesting to note that the proposals for MAFR in the US date back to 1977, when it was rejected by the Cohen Commission. MAFR was also considered and rejected by Congress in 2002 during the deliberations that culminated in the passing of the Sarbanes-Oxley Act of 2002. MAFR was further rejected by the GAO in its November 2003 Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services. See GAO Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services "Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation" (2003) http://www.gao.gov/new.items/d04216.pdf (accessed 2017-09-22).

[64] See, for eg, AICPA Letter to PCAOB Raises Concerns About Mandatory Audit Firm Rotation *Journal of Accountancy* (2011) http://www.journalofaccountancy.com/news/2011/dec/20114896.html (2017-09-22).

[65] *Ibid*.

[66] *Ibid*.

[67] In its November 2003 report, GAO had concluded that MAFR would not be the most efficient way of enhancing auditor independence and audit quality as it would lead to additional costs and loss of institutional knowledge. See GAO http://www.gao.gov/new.items/d04216.pdf 50.

report to Congress on the potential effects (including the costs and benefits) of MAFR.[68]

Consequently, the US has, for the time being, opted to continue with its existing MAPR requirements and not to implement MAFR.[69] The rationale for disregarding MAFR is that the disadvantages of MAFR (which include additional costs, disruptions, loss of institutional knowledge, reduction in audit quality and increased risk of audit failure) outweigh the perceived benefits that may result from MAFR. However, it is essential to underscore that the debate on MAFR as a strategy to strengthen auditor independence and audit quality is not yet over in the US. This is so because Congress has not rejected MAFR outright but has rather required further investigation of the issue. At some point, the GAO will report to Congress on the potential effects of MAFR. Congress would then have to assess the benefits and drawbacks of MAFR as a regulatory tool in this important area of corporate law and determine whether it must be implemented in the US. An important lesson to be drawn from the US experience in this regard is that it is crucial for any jurisdiction wanting to adopt MAFR at least to take into account its costs and benefits. The implementation of MAFR in practice should then seek to maximise its benefits while minimising it costs.

4 2 Canada

Canada was one of the first jurisdictions to implement mandatory auditor rotation in the form of MAFR, which was introduced following the Home Bank of Canada failure in 1923.[70] The Bank Act of Canada required chartered banks to appoint two audit firms and one of the two firms was required to rotate every two years.[71] The underlying rationale for adopting MAFR in Canada was to improve the independence and objectivity of statutory auditors for banks. However, in 1991, Canada abandoned MAFR on the ground that the costs of rotation exceeded the benefits of rotation.[72] An important lesson that may be drawn from the Canadian experience is that mandatory auditor rotation in the form of MAFR would be undesirable where its costs outweigh its benefits. Thus, even for jurisdictions that adopt MAFR, it is important to continue to analyse its costs and benefits.

[68] See 113th Congress 1st Session House of Representatives Report 113–142 "Audit Integrity and Job Protection Act" (2013) https://www.congress.gov/113/crpt/hrpt142/CRPT-113hrpt142.pdf (accessed 2017-09-22).

[69] See Vincent "PCAOB Abandons Auditor Rotation" (6 February 2014) *CFO Journal* http://ww2.cfo.com/auditing/2014/02/pcaob-abandons-auditor-rotation/ (accessed 2017-09-22); Chasan "PCAOB's Auditor Rotation Project is Essentially Dead" (5 February 2014) *The Wall Street Journal* https://blogs.wsj.com/cfo/2014/02/05/pcaobs-auditor-rotation-project-is-essentially-dead/ (accessed 2017-09-22); Cameran, Negri and Pettinicchio "The Audit Mandatory Rotation Rule: The State of the Art" 2015 3(2) *The Journal of Financial Perspectives* 61 63–64.

[70] See Everett, Green and Neu "Independence, Objectivity and the Canadian CA Profession" 2005 16 *Critical Perspectives on Accounting* 415 422; Green "Auditor Independence in Canada: A Historical Perspective – From Shareholder Auditors to Modern-Day Audit Committees" 2006 5(1) *Accounting Perspectives* 37–65, for a history of the attempts by the legislature and regulatory bodies in Canada to strengthen auditor independence in view of the asymmetric relationship that exists between statutory auditors and companies.

[71] GAO http://www.gao.gov/new.items/d04216.pdf 88.

[72] GAO http://www.gao.gov/new.items/d04216.pdf 89.

4 3 Australia

In Australia, mandatory rotation of auditors was introduced by section 324DA in Division 5 of the Corporations Act 2001 in order to enhance auditor independence. The section prohibits an individual who has played a "significant role" in an audit of a listed company or listed registered scheme for five successive financial years (eligibility term) from playing a "significant role" in the audit of such company or scheme for the subsequent financial year.[73] It follows from the above provisions regulating auditor rotation, as read with the definition of "play a significant role" in section 9, that the Corporations Act 2001 provides for MAPR and not MAFR. The Australian approach in this regard follows the approach adopted by the US under section 10A(*j*) of the Securities Exchange Act of 1934, which, as discussed above, provides for MAPR only every five years.

However, unlike section 10A(*j*) of the Securities Exchange Act of 1934 in the US, the Corporations Act 2001 specifically provides for a period of two consecutive financial years that must first expire before the same audit partner may be re-appointed to audit the company.[74] The Corporations Act 2001 also makes it clear that the audit partner's maximum tenure of five years may be extended.[75] The five-year term may be extended for not more than two consecutive financial years by the directors of the company in accordance with section 324DAA. This is a significantly positive feature of the Corporations Act 2001 as it affords listed companies leeway to extend the rotation period where necessary. Notably, the approval of such extension by the directors is subject to stringent controls set out in section 324DAB, presumably to prevent abuse.[76] It is submitted that affording listed companies the leeway to extend the rotation period (but subject to appropriate controls) would enable these companies to avoid *inter alia* the unduly disruptive impacts of having to rotate the audit partner, for example, during the course of a merger, acquisition or other business re-structuring exercise.

The Corporations Act 2001 provides for direct and strict penalties for contravention of its provisions relating to MAPR. A contravention occurs where an individual plays a significant role in the audit of a listed company or listed registered scheme while not being eligible to play that role. The

[73] A person plays a "significant role" in the audit of a company if the person is appointed as an individual auditor of a company or scheme for the financial year and acts as an auditor for the company or scheme for that financial year, or prepares an audit report in relation to a financial report of such entity. Where a firm is appointed as auditor, a person plays a "significant role" in the audit of a client company if such person is a registered auditor and acts as a lead auditor, or review auditor, in relation to an audit of the client company for the particular financial year (or for a half-year falling within that financial year). See the definition of "play a significant role" in the audit of a company in s 9 of the Corporations Act 2001.

[74] S 324DA(1)(*a*) of the Corporations Act 2001.

[75] S 324DAA of the Corporations Act 2001.

[76] The directors must not approve the extension of the individual's eligibility tenure unless it is in accordance with a recommendation by the audit committee and reasons are provided as to why the audit committee is satisfied that the approval is consistent with maintaining audit quality and would not lead to a conflict of interest situation. See s 324DAB of the Corporations Act 2001.

contravention is made by the individual concerned[77] as well as by any member of the audit firm who is not the individual concerned,[78] or (in the case of an audit company) the audit company and directors of the audit company.[79] The contravention may lead to strict criminal offences being imposed on the implicated person.[80] These strict penalties, which may be imposed on individuals and audit firms or audit companies for violation of the provisions on MAPR, are designed to ensure compliance with the MAPR provisions of the Corporations Act 2001.

Although Australia (like the US) has not implemented MAFR, MAPR alone may not be sufficient to ensure auditor independence and audit quality. This is so because loyalty to the client company and the desire to maintain a long relationship with the client company is likely to be equally important to all audit partners within an audit firm.[81]

It is also noteworthy that the Australian Securities and Investments Commission (ASIC)[82] has indicated that MAFR may be considered by regulators as an option to reinforce audit quality in Australia.[83] This followed the revelation of a general decrease in audit quality in the ASIC's audit inspection program report for 2011–12.[84] The ASIC's recurring concern in its audit inspection program reports is that there is need for improvement in the level of independence and professional scepticism exercised by auditors.[85]

[77] See s 324DB of the Corporations Act 2001.

[78] A member of the audit firm contravenes the Corporations Act 2001 in these circumstances if the member becomes aware that the individual is not eligible to play that role but the member fails to take the necessary steps (as soon as possible thereafter) to ensure that the audit firm resigns as auditor of the company or scheme or to ensure that the individual stops acting as a lead or review auditor on behalf of the firm in such case. See s 324DC(1) of the Corporations Act 2001.

[79] See s 324DD of the Corporations Act 2001.

[80] See s 324DC(2)–(4), and s 324DD(2)–(5) of the Corporations Act 2001.

[81] Ncube 2010 *Acta Juridica* 63.

[82] The ASIC is a regulatory body charged with the general administration of the Corporations Act 2001. See s 5B of the Corporations Act 2001.

[83] Durkin and King "Failing Audit Firms Will Face Crackdown: ASIC" *Australian Financial Review* (4 December 2012) http://www.afr.com/news/failing-audit-firms-will-face-crackdown-asic-20121204-jijiu (accessed 2017-09-23); Durkin and King "ASIC Threatens Auditors With Mandatory Rotation" *Australian Financial Review* (5 December 2012) http://www.afr.com/p/national/professional_services/asic_threatens_auditors_with_mandatory_T08zuuBkSqTtX6GQkelQqI (accessed 2017-09-23); Medcraft "Auditors Need to Lift Game" *Australian Financial Review* (18 December 2012) http://www.afr.com/p/opinion/auditors_need_to_lift_game_dEyLBNgTx81xACXlu61lcN (accessed 2017-09-23).

[84] See Australian Securities and Investments Commission "Audit Inspection Program Report for 2011-12" Report 317 (2012) http://download.asic.gov.au/media/1344098/rep317-published-4-December-2012.pdf (accessed 2017-09-23) par 40–43.

[85] For eg, in its Audit Inspection Program Report for 2012–13, released on 27 June 2014, the ASIC had the following to say:

"49 Across all of the firms inspected, our review of audit files identified many cases where we had concerns about the sufficiency and appropriateness of evidence obtained by auditors to support their conclusions on significant areas of the audit.

50 Our reviews of audit files showed, in our view, insufficient professional skepticism was applied, particularly in relation to fair value measurement, impairment testing, and going concern assessments. Exercising professional skepticism is a critical part of conducting quality audits. Professional skepticism means the auditor makes a critical assessment, with a questioning mind, of the validity of the audit evidence obtained and management's judgements on accounting estimates and treatments.

This serves to illustrate that, as in other modern jurisdictions, the central issues of ensuring audit quality and auditor independence are far from over in Australia. Thus, the debate on strategies to strengthen auditor independence and audit quality will probably continue in Australia. At some point, the Australian regulators will have to determine whether, in addition to the existing MAPR requirements, they should introduce strategies such as MAFR.

The important lessons to be derived from the Australian experience include that MAPR alone may not be enough to ensure audit quality. Furthermore, a degree of flexibility may be necessary to allow companies an opportunity to extend the set audit partner's tenure period where appropriate. However, this should not be for a very long period. The Corporations Act 2001 provides for a maximum period of two years in this regard. There should also be appropriate checks and balances put in place to ensure that this extension is not abused. In addition, direct and strict penalties should be prescribed for contravention of the MAPR provisions. It is submitted that these features of the Corporations Act 2001, which are meant to afford some degree of flexibility and to ensure compliance with the requirements on auditor rotation, can be borrowed by other jurisdictions, not only in the context of MAPR, but in the context of MAFR as well.

4 4 European Union

In the EU, mandatory auditor rotation is regulated by Regulation 537/2014 and Directive 2014/56/EU, which took effect on 17 June 2016 (EU Regulation).[86] The EU's underlying policy justification for mandatory auditor

51 In particular, we found examples where auditors appeared to have:

(a) been over-reliant on, or readily accepted, the explanations and representations of the management of audited entities without challenging matters such as key underlying assumptions; or

(b) sought out evidence to corroborate estimates or treatments rather than appropriately challenging them (footnote omitted)."

The ASIC has further found that there were instances of non-compliance with the statutory and professional standards, which could undermine the actual or apparent independence and objectivity of auditors. See Australian Securities and Investments Commission "Audit Inspection Program Report for 2012–13" Report 397 (2014), http://download.asic.gov.au/media/1344614/rep397-published-27-June-2014.pdf (2017-09-23) par 49–52 and par 88. These concerns are strikingly similar to those expressed by the ASIC in its Audit Inspection Program Report for 2011–12 and in some of its reports for the previous years.

[86] See Regulation 537/2014 of the European Parliament and of the Council of 16 April 2014 and Directive 2014/56/EU http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0537&from=EN (accessed 2017-09-24) (EU Regulation). The EU Regulation applies to EU member states, including those member states that already had MAFR rules in place – for example, Italy, France, Austria, Poland, Portugal and the Netherlands. They also include member states such as Spain, Czech Republic and Turkey, which had previously adopted MAFR, but subsequently abolished it. For a list of member states that, prior to the implementation of the EU Regulation, had adopted MAFR requirements, see, generally, Ewelt-Knauer, Gold and Pott "What Do We Know About Mandatory Audit Firm Rotation?" (2012) *ICAS* https://assets.publishing.service.gov.uk/media/5329dbc1ed915d0e5d0000c1/icas_mafr_report.pdf (accessed 2017-09-24); Deloitte LLP "Re: March 21, 2012 Public Meeting on Auditor Independence and Audit Firm Rotation" (12 March 2012) https://pcaobus.org//Rulemaking/Docket037/ps_Echevarria.pdf (accessed 2017-09-24); Cameran, Negri and Pettinicchio 2015 *The Journal of Financial Perspectives* 64–65.

rotation in the form of both MAPR and MAFR is to reinforce auditor independence, strengthen professional scepticism and increase audit quality.[87]

MAPR is regulated by Article 17(7) of the EU Regulation, which requires audit partners to rotate every seven years from the date of their appointment. Notably, the MAPR period in the EU is longer than the five-year period in the US and Australia.[88] Article 17(7) further provides for a cooling-off period of three years during which audit partners must not participate in the audit of the audited entity.[89] Providing for a specific cooling-off period following the termination of the audit partner's appointment is in line with the approach in Australia, although Australia (as discussed above) has a shorter cooling-off period of two years. EU member states are, however, permitted to prescribe a shorter period (but not a longer period) for MAPR than the seven years. This flexibility given to member states to prescribe a shorter maximum period for MAPR may lead to disharmony in the regulation of this aspect within the EU as there may be varying maximum tenure periods in different countries.[90]

A notable feature of the EU Regulation is the introduction of MAFR requirements in relation to all public interest entities (PIEs) as defined[91] and in addition to the already-existing MAPR rules. As far as MAFR is concerned, the EU Regulation provides for an initial engagement period of one year and a maximum engagement period of ten years for auditors of PIEs.[92] However, EU member states are permitted to set an initial engagement period of more than one year as well as a maximum engagement period that is shorter than (not longer than) ten years.[93] Furthermore, member states are permitted to extend the maximum

[87] See par 21 of the preamble to the EU Regulation.

[88] Note, however, that it is possible (as discussed above) to increase the five-year tenure period for audit partners in Australia by not more than two consecutive financial years in accordance with s 324DAA of the Corporations Act 2001. In the US, this period may not be extended.

[89] Article 17(7) has extended this cooling-off period from a previous two years to the current three years.

[90] This is already evident from the varying maximum periods for MAPR among different EU member states. See, for eg, Cameran, Negri and Pettinicchio 2015 *The Journal of Financial Perspectives* 64–65.

[91] The term "public interest entities" is defined to mean:

- entities governed by the law of a member state whose transferable securities are admitted to trading on a regulated market of any member state within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC;
- credit institutions as defined in point 1 of Article 3(1) of Directive 2013/36/EU of the European Parliament and of the Council, other than those referred to in Article 2 of that Directive;
- insurance undertakings within the meaning of Article 2(1) of Directive 91/674/EEC; or
- entities designated by member states as public interest entities, for instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees.

See Article 2(13) of the Directive 2006/43/EC on Statutory Audits of Annual Accounts and Consolidated Accounts (as amended by Directive 2014/56/eu of 16 April 2014) http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2014.158.01.0196.01.ENG (accessed 2017-09-24).

[92] Article 17(1) of the EU Regulation.

[93] Article 17(2)(a) of the EU Regulation.

engagement period to the maximum of twenty years if a public audit tender has been conducted[94] or twenty-four years where there are joint auditors appointed.[95] It is, therefore, possible to extend the maximum rotation period of ten years but such extension may only be made if (upon a recommendation of the audit committee, the administrative or supervisory body) the PIE tables the proposal for renewal of the engagement to a shareholder vote at a general meeting and that proposal is approved.[96] These provisions represent considerable flexibility in the EU on this issue, but subject to appropriate checks and balances.

In cases where there are joint auditors or where a public tender has been conducted, it is further possible for a PIE, after the expiry of the extended maximum engagement period (that is, 20 years where a public audit tender has been conducted or 24 years in the case of joint auditors), to request an extension from the competent regulatory authority to re-appoint the auditor or audit firm for an additional period not exceeding two years.[97] This can only be done in "exceptional" circumstances.[98] The provision, however, does not prescribe what those "exceptional" circumstances would be. It is left to the discretion of the regulatory authority to determine whether exceptional circumstances warranting such extension exist. The absence of a closed list of the situations in which an extension could be granted allows the competent regulatory authority to determine each request on its own facts. It is, therefore, possible under the rule, where there are joint auditors, for a PIE to engage the same auditors for a maximum period of twenty-six years (that is, 10+14+2 years). In cases where a single audit firm is appointed, it is possible for a PIE to retain the same firm for a maximum of 22 years (that is, 10+10+2 years). After the expiry of the above maximum durations, the audit firm and any members of its networks within the EU may not audit the same PIE within the following four-year period.[99] There is, therefore, a cooling-off period of four years for the audit firm. This cooling-off period also applies to its network firms.

As with MAPR rules, the flexibility given to member states to prescribe a shorter maximum period for MAFR may lead to disharmony in the regulation of this aspect within the EU as there will be varying maximum tenure periods in different countries. Considering the global nature of audits,[100] it can be argued that there should be greater harmonisation of regulations relating to audits, especially in a region such as the EU that is characterised by considerable economic integration. In the same vein, there would be a need for member states such as Italy, France, Austria, Turkey and the Netherlands, which already provide for MAFR in their domestic laws,[101] to align their regulations with the provisions of the EU Regulation.

[94] Article 17(4)(a) as read with Article 16(2) and (5) of the EU Regulation.

[95] Article 17(4)(b) of the EU Regulation.

[96] Article 17(5) of the EU Regulation.

[97] Article 17(6) of the EU Regulation.

[98] *Ibid*.

[99] Article 17(6) of the EU Regulation.

[100] Doty 2012 *Texas LR* 1907.

[101] See Cameran, Negri and Pettinicchio 2015 *The Journal of Financial Perspectives* 64–65. For eg, Italy has a maximum engagement period of nine years; France has a maximum

According to the EU Regulation, the audit engagement period must be calculated from the first financial year covered in the audit engagement letter in which the audit firm is appointed for the first time to perform consecutive audits for the same PIE.[102] The "audit firm" includes other firms acquired by the audit firm or that have merged with it.[103] In certain circumstances, there may be uncertainty as to the date on which the auditor began performing consecutive audits for the PIE – for example, owing to firm mergers, acquisitions, or changes in ownership structure. According to Article 17(8) of the EU Regulation, in such circumstances the auditor must immediately report the uncertainty to the competent authority. The competent authority must ultimately determine the relevant date for the purposes of MAFR.[104] It is submitted that this is a quite progressive provision as it addresses a situation where audit firm mergers may result in uncertainties. However, it is submitted that one of the major flaws of Article 17(8) is that while it addresses the merger or acquisition of audit firms, it is silent on what the effect of mergers or acquisitions between or among PIEs would be on the application of the MAFR requirements.

4 5 India

In India, MAPR and MAFR requirements are regulated by the Companies Act 2013.[105] The requirements apply to listed companies or companies belonging to a prescribed class of companies.[106] This is somewhat different from the general trend in the EU (and in Australia and the US in relation to MAPR) where the requirements for mandatory auditor rotation apply to listed companies and/or PIEs, and where non-listed companies and private companies are excluded from the application of such requirements. Notably, the MAPR and MAFR requirements in India have not taken away a

engagement period of six years for joint auditors, which may be renewed; Austria has a maximum engagement period of five years for governmental companies; and the Netherlands has a maximum engagement period of eight years for PIEs. Although the Dutch Audit Profession Act introduced a shorter maximum period of eight years for MAFR with a two-year cooling-off period (with effect from 1 January 2016), Dutch authorities have indicated that they may align the provisions of this Act with the MAFR requirements in terms of the EU.

[102] Article 17(8) of the EU Regulation.

[103] *Ibid*.

[104] Article 17(8) of the EU Regulation.

[105] See s 139 of the Companies Act 2013, which deals with the appointment of auditors.

[106] S 139(2) of the Companies Act 2013. The companies to which mandatory auditor rotation applies are the following (excluding one-person companies and small companies):

(a) all unlisted public companies having paid-up share capital of ten crore rupees or more;

(b) all private limited companies having paid-up share capital of twenty crore rupees or more;

(c) all companies having paid-up share capital of below the threshold limit mentioned in (a) and (b) above, but having public borrowings from financial institutions, banks or public deposits of fifty crore rupees or more.

See s 5 of the Companies (Audit and Auditors) Rules, 2014 (Audit Rules). It appears that in the case of non-listed companies or companies that do not belong to any prescribed class of company, the same individual auditor or audit firm may be re-appointed every five years.

company's existing right to remove an auditor or the auditor's right to resign as auditor of the company.[107]

In relation to MAPR, section 139(2)(*a*) of the Companies Act 2013 provides that an individual must not be appointed or re-appointed as an auditor for more than five consecutive years.[108] This means that the individual auditor must rotate every five years. The Companies (Audit and Auditors) Rules, 2014 (Audit Rules) make it clear that a break in the audit partner's term for a continuous period of five years will be regarded as fulfilling the MAPR (and MAFR) requirements.[109] Furthermore, section 139(2)(*b*)(i) specifically provides for a cooling-off period of five years during which an individual auditor must not be re-appointed as auditor of the same company. This cooling-off period of five years is significantly longer than the three years under Article 17(7) of the EU Regulation, and the two years under the Australian Corporations Act 2001. The provision of a specific cooling-off period in the context of MAPR in section 139(2)(*b*)(i) of the Companies Act 2013 is, nevertheless commendable as it creates certainty for companies and auditors. Although the Companies Act 2013 does not provide for the extension of an audit partner's tenure,[110] it is interesting to note that section 139(3) allows members of a company to require that the audit partner and his team be rotated at such intervals as may be resolved by members. There are no similar provisions in the equivalent legislation of the other jurisdictions discussed in this article.

As far as MAFR is concerned, section 139(2)(*b*) provides that an audit firm must not be appointed or re-appointed as auditor for more than two terms of five consecutive years. This means that audit firms must rotate every ten years. Section 139(2)(*b*)(ii) provides for a cooling-off period of five years in the case of MAFR. As is the case under Article 17 of the EU Regulation, the cooling-off period is also applicable to audit firms with a common partner or partners to the audit firm whose tenure has expired.[111] In terms of paragraph 6(3)(ii) of the Audit Rules, the incoming auditor or audit firm must not be associated with the outgoing auditor or audit firm under the "same network" of audit firms.[112] Explanation II(b) in paragraph 6(3) of the Audit Rules further provides that "if a partner, who is in charge of an audit firm and also certifies the financial statements of the company, retires from the said firm and joins another firm of chartered accountants, such other firm shall also be ineligible to be appointed for a period of five years."

It is also noteworthy that section 139(2) afforded existing companies a transition period of three years from the date of commencement of the Companies Act 2013[113] before such companies would be required to comply

[107] See s 139(2) of the Companies Act 2013.

[108] See the explanation in s 139 that "appointment" includes "re-appointment".

[109] See Explanation II in paragraph 6(3) of the Audit Rules. This provision also applies in the context of MAFR.

[110] See, for eg, s 324DAA of the Corporations Act 2001 in Australia.

[111] See proviso to s 139(2) of the Companies Act 2013, read with s 6 of the Audit Rules.

[112] The term "same network" is defined as including "the firms operating or functioning, hitherto or in future, under the same brand name, trade name or common control." See Explanation I in s 6 of the Audit Rules.

[113] 1 April 2014.

with the MAPR and MAFR requirements. Such transition requirements are welcome as their purpose is to afford companies an opportunity to prepare for the initial rotation in order to avert or mitigate the disruptive effects of a rotation.

It is submitted that the MAFR requirements in the Companies Act 2013 have certain shortcomings that the legislature in India should address. For example, unlike the EU Regulation, the Companies Act 2013 does not give companies leeway to extend the MAFR period where necessary. It is submitted that giving companies a limited degree of flexibility to extend the MAFR period may be necessary in certain exceptional situations. It should, however, be subject to appropriate safeguards in order to prevent abuse and to ensure that limited extension is resorted to only where it is necessary. Furthermore, the application of the MAFR requirements to private companies and non-listed companies in India may be problematic. Careful thought should be given to the categories and sizes of company that should be exempted from these onerous requirements. The calculation of the MAFR period under the Companies Act 2013 also raises some uncertainties. It is not clear whether the period during which an audit firm served as the appointed auditor of a company prior to the company becoming listed or belonging to a prescribed class of company would be considered in determining when the audit firm must rotate. This should be clarified in order to provide companies and audit firms with certainty. The Companies Act 2013 is also silent on the impact that audit firm mergers, acquisitions, or changes in ownership structure would have on MAFR requirements. In addition, the Companies Act 2013 has not addressed the effect of amalgamations or mergers of companies on the MAFR requirements.

5 EVALUATING THE PROS AND CONS OF MANDATORY ROTATION OF AUDITORS

The above discussion has revealed that mandatory auditor rotation, as a regulatory strategy to enhance auditor independence, objectivity, professional scepticism and audit quality, is certainly not a new concept. There has been widespread acceptance of MAPR across modern jurisdictions, albeit with minor variations in its implementation – for example, varying cooling-off periods. However, the issue of whether MAFR is an appropriate approach and strategy to regulate auditor independence, objectivity, professional scepticism and audit quality is mired in uncertainty, with conflicting views in different jurisdictions. This is further confirmed by the fact that, unlike MAPR, there has not been a consistent acceptance and implementation of MAFR across many modern jurisdictions. Some of the leading jurisdictions such as the US, Canada and Australia, as indicated above, do not have MAFR. The US has, as discussed above, considered MAFR and rejected it for the time being. Canada, and certain EU member states prior to the adoption of the EU Regulation, adopted MAFR and later abandoned it.[114]

[114] Furthermore, (although not discussed in this article) there are other countries too that, at some point, adopted MAFR and then reversed it – for eg, Brazil, Korea, and Singapore.

The literature and experience in the jurisdictions discussed above illustrate that the debates on MAFR centre on auditor independence, audit quality and the costs of rotation. According to proponents of the rule, MAFR benefits financial markets by preventing auditor entrenchment, economic dependence of the auditor on the audited company, over-familiarity with the audited company and undue pressure on the auditor to maintain a long relationship with the audited company.[115] They believe that MAFR enhances auditor independence (both actual independence and independence in appearance), objectivity and, ultimately, audit quality.[116] This argument is valid since investors and other end users of audited financial statements can suspect bias and lack of independence between the auditors and the management of the audited company in the context of extended auditor tenure.[117] This may lead to loss of confidence in the accuracy of the financial statements and the financial market. A further argument in favour of MAFR is that it has the benefit of the "fresh look" – namely, that it allows the new audit firm appointed following the rotation to examine the company's financial statements with fresh and critical eyes.[118] It has therefore been argued that the benefits of the protective role that the "fresh look" brings to end users of a company's financial statements outweigh the costs of MAFR.[119] In addition, MAFR is viewed as one way of opening up the highly concentrated market for auditors, which has traditionally been dominated by the Big Four audit firms in most jurisdictions.[120] MAFR requirements are therefore expected to increase competition by extending to audit firms (other than the four currently dominant firms) the opportunity to audit listed companies and PIEs as well.

Critics of MAFR argue that there is a lack of clear and sufficient evidence that MAFR strengthens auditor independence and audit quality.[121] On the contrary, they contend that MAFR may reduce audit quality through loss of vital institutional knowledge and disruptions, particularly in the initial years of the new auditor's tenure and in special circumstances like mergers and acquisitions, or in complex and industry-specific businesses, or in multinational companies.[122] A further argument advanced against MAFR is that it increases costs on both audit firms and audited companies.[123] It has further been argued that MAFR may result in complexities, especially for

[115] GAO http://www.gao.gov/new.items/d04216.pdf 13; Cameran, Negri and Pettinicchio 2015 *The Journal of Financial Perspectives* 66.

[116] See discussion above regarding the value of auditor independence to the financial markets.

[117] See Cameran, Negri and Pettinicchio 2015 *The Journal of Financial Perspectives* 66.

[118] *Ibid*.

[119] GAO http://www.gao.gov/new.items/d04216.pdf 13.

[120] See Cameran, Negri and Pettinicchio 2015 *The Journal of Financial Perspectives* 66–67.

[121] See Cameran, Negri and Pettinicchio 2015 *The Journal of Financial Perspectives* 67–72 as well as the conflicting studies referred to therein.

[122] See PricewaterhouseCoopers "Point of View: Mandatory Audit Firm Rotation: Other Changes Would Be Better for Investors" (March 2013) https://www.pwc.com/gx/en/audit-services/publications/assets/pwc-pointofview-mandatoryrotation.pdf (accessed 2017-09-24) 2–3; GAO http://www.gao.gov/new.items/d04216.pdf 13; Cameran, Negri and Pettinicchio 2015 *The Journal of Financial Perspectives* 67.

[123] See PricewaterhouseCoopers https://www.pwc.com/gx/en/audit-services/ publications/ assets/pwc-pointofview-mandatoryrotation.pdf 2–3; GAO http://www.gao.gov/new.items/ d04216.pdf 13; Cameran, Negri and Pettinicchio 2015 *The Journal of Financial Perspectives* 67.

multinational companies, which may be subject to different MAFR requirements.[124] MAFR has also been criticised on the ground that it undermines the audit committee's ability to discharge its statutory function of choosing the most suitable audit firm to audit the company.[125] It has, accordingly, been argued that the increased risk of audit failure and the increased costs of MAFR outweigh the positive impacts of what has been described as the "fresh look" by a new audit firm.[126] Moreover, it has been said that MAFR is unnecessary in view of the already-existing requirements for auditor independence, MAPR and the oversight of auditors by independent audit committees.[127]

The arguments in favour of MAFR – namely, the strengthening of auditor independence (both actual independence and independence in appearance), objectivity, professional scepticism and audit quality – are cogent. They arguably outweigh the arguments against MAFR discussed above. This is so, particularly in view of the vital role that the statutory audit of companies plays in the capital markets and the value of auditor independence (as discussed above) and the concerns that MAPR alone is inadequate to ensure auditor independence and audit quality. Opening up the traditionally concentrated audit market is also a valid consideration.

Nevertheless, the arguments that have been advanced against MAFR are important and should not be ignored. It is submitted that the arguments that have been advanced against MAFR should be taken into account when formulating new MAFR requirements, or refining existing ones, as well as when implementing such rotation in practice. The literature and the experience in jurisdictions that have already adopted MAFR (as discussed above) show that MAFR may have far-reaching implications for companies and markets. Regulators, audit firms and companies should consider these concerns. For instance, transitioning from an incumbent audit firm to a new firm can be disruptive and costly. Therefore, regulators should draft rules in such a way that they minimise disruptions and costs while maximising the benefits of MAFR. Regulators should also ensure that the MAFR rules are clear and unambiguous to avoid uncertainty in practice. It is also imperative that companies subject to MAFR requirements should plan and prepare in advance for the rotation to ensure that they manage it in a less disruptive way.[128] This, it has been opined, may necessitate a certain level of cooperation between the incumbent and incoming audit firm.[129] Such cooperation between outgoing and incoming audit firms should, however, not undermine the "fresh look" that the incoming firm should bring to the audit.[130] In the same vein, audit firms should prepare in advance and

[124] See PricewaterhouseCoopers https://www.pwc.com/gx/en/audit-services/publications/assets/pwc-pointofview-mandatoryrotation.pdf 2–3.

[125] *Ibid*.

[126] GAO http://www.gao.gov/new.items/d04216.pdf 13.

[127] *Ibid*.

[128] Tapestry Networks "Mandatory Audit Firm Rotation: The Dutch Experience" (2014) http://www.ey.com/Publication/vwLUAssets/EY-acls-view-points-dutch-audit-firm-rotation/$FILE/EY-acls-view-points-dutch-audit-firm-rotation.pdf 4 (accessed 2017-09-28).

[129] Tapestry Networks http://www.ey.com/Publication/vwLUAssets/EY-acls-view-points-dutch-audit-firm-rotation/$FILE/EY-acls-view-points-dutch-audit-firm-rotation.pdf 5.

[130] *Ibid*.

manage the need to move their staff from one client to another smoothly.[131] They should also prepare in advance for frequent and multiple tenders.[132]

Although it is still early days, concerns have been expressed that MAFR requirements in the EU have not yet increased competition in the audit industry.[133] It has been observed that both large and mid-tier firms are grappling with recruitment challenges and the need to prepare proposals for multiple tenders.[134] Large public companies, especially multinational companies, are likely to have a limited choice of audit firms, as these companies have traditionally been audited by the Big Four audit firms (KPMG, PricewaterhouseCoopers, Ernst & Young, and Deloitte & Touche), which generally have the necessary capacity, skills and experience to audit such large companies.[135] It is suggested, in this regard, that market players should come up with innovative ways of navigating these obstacles in practice. One such way is for companies, especially big companies, to try to capacitate mid-tier and smaller audit firms by appointing them as joint auditors alongside one of the traditional Big Four audit firms. Another way is for companies to increase the capacity of mid-tier and smaller firms by appointing them to perform non-audit, tax and consultancy work.

6 THE LAW IN SOUTH AFRICA

6 1 MAPR in South Africa

In South Africa, the Companies Act,[136] in line with the Sarbanes-Oxley Act of 2002 (US) and the Corporations Act 2001 (Australia), does not require MAFR. Section 92(1) of South Africa’s Companies Act provides for mandatory rotation of an “individual” who serves as “auditor or designated auditor” every five years. Section 92 clearly requires MAPR every five years as it is only the designated individual or partner within the audit firm (and not the audit firm) that is required to rotate. The section is presumably meant to preserve the independence of the individual who serves as “auditor or designated auditor of the company”[137] by preventing their entrenchment, over-familiarity with the audited company and any undue pressure on such individual to maintain a long relationship with the audited company.[138] The initial maximum period for MAPR is the same as that in the US, India and Australia – namely, five years.

MAPR requirements apply to state-owned companies, public companies (regardless of size or whether they are listed or unlisted) and certain private companies (as discussed above) that are required to have their annual

[131] *Ibid*.

[132] *Ibid*.

[133] *Ibid*.

[134] *Ibid.*

[135] Tapestry Networks http://www.ey.com/Publication/vwLUAssets/EY-acls-view-points-dutch-audit-firm-rotation/$FILE/EY-acls-view-points-dutch-audit-firm-rotation.pdf 3.

[136] Act 71 of 2008.

[137] See s 92(1) of Act 71 of 2008.

[138] Stewart 2006 *Journal of Corporate Law Studies* 332; Garcia-Blandon and Argiles 2015 *Journal of International Accounting, Auditing and Taxation* 91.

financial statements audited. This is significantly different from the approach in the US, EU and Australia (as discussed above) where the rules are applicable to listed companies and public interest companies, and not to private companies or non-listed companies. The South African Companies Act, in this regard, closely resembles the approach under the Indian Companies Act 2013 in terms of which MAPR applies to listed companies, certain categories of non-listed companies and certain categories of private companies. However, one significant difference between the South African Companies Act and the Indian Companies Act 2013, in this regard, is that the latter excludes certain non-listed public companies (smaller public companies) from the MAPR requirements.

Section 92(2) specifically addresses the situation where there is a break in the lead audit partner's tenure before the expiry of the stipulated maximum tenure period of five financial years. In terms of this section, if the individual ceases to be an auditor or designated auditor of a company after serving as such for two consecutive financial years, the individual may not be appointed again in that capacity until after the lapsing of two further financial years.[139] Section 92(2) is, in this regard, advanced when compared to the equivalent provisions in the US, Australia and the EU, which (as discussed above) do not contain such a provision.

Section 92(3) is another quite progressive provision of the South African Companies Act. In terms of this provision, where a company has appointed two or more "persons" as joint auditors, the company is required to manage their rotation in such a manner that they do not both cease to hold office in the same year.[140] This helps to prevent undue disruptions that may result from joint auditors rotating at the same time.

Section 92(2) provides for a cooling-off period of two financial years within which an audit partner whose five-year tenure has come to an end (or who has been serving as the company's auditor or designated auditor for at least two consecutive years) must not be re-appointed to audit the same company. Specifying the cooling-off period for MAPR is important as it provides certainty for companies and auditors. It contributes to predictability in the regulation of company audits.[141] The cooling-off period of two years is the same as that provided for in the Australian Corporations Act 2001. It is, however, debatable whether this cooling-off period is long enough for the audit partner to regain his or her independence from the company and its management. As discussed above, the EU Regulation provides for a cooling-off period of three years while the Indian Companies Act 2013 provides for a cooling-off period of five years.

The South African Companies Act closely follows the US approach as far as it does not provide for the possibility of extending an audit partner's tenure where necessary. This approach may be criticised on the ground that it is too rigid. Companies may need to extend an audit partner's tenure in exceptional circumstances in order to avoid undue disruptions caused by implementing a rotation – for example, in the midst of corporate restructuring

[139] S 92(2) of Act 71 of 2008.

[140] S 92(3) of Act 71 of 2008.

[141] See s 7(*l*) of Act 71 of 2008.

exercises. Notably, the Australian Corporations Act 2001 and the Indian Companies Act 2013 (as discussed above) allow for such flexibility.[142] Even though the EU Regulation does not provide for a possible extension of an audit partner's tenure, it already provides for a longer audit-partner tenure of seven years. Such longer tenure gives companies enough leeway to prepare for disruptions that may be caused by rotation in exceptional circumstances.

The South African Companies Act may further be criticised on the ground that, while addressing the concern that an audit partner's long association with the audited company might influence the audit partner's independence and objectivity, it does not address an equally important concern that extended audit-firm tenure may also impair auditor independence and objectivity.

In addition, the Companies Act does not impose a positive duty on companies to report the audit partner's tenure and information regarding rotation. It is critical that such information be disclosed in order to promote greater transparency and accountability. Mandatory disclosure of such information would also enable shareholders to cast their votes on the resolution to appoint or re-appoint the auditor in an informed manner.[143]

6 2 The MAFR rule in South Africa

On 2 June 2017, the Independent Regulatory Board for Auditors (IRBA)[144] published a rule (MAFR rule) that requires auditors of public interest entities (PIEs)[145] to implement MAFR.[146] The MAFR rule prohibits an audit firm, including a network firm, from serving as auditor of a PIE for more than ten consecutive financial years. This means that a firm that is the appointed auditor of a PIE is compelled to rotate after ten years. Such firm must not, according to the MAFR rule, be reappointed as the auditor of the particular PIE until after the expiry of a cooling-off period of at least five financial years.

[142] See s 7(*b*)(ii) of Act 71 of 2008, which provides for the creation of flexibility in the maintenance of companies as one of the purposes of this Act.

[143] See s 90(1) and (1A) of Act 71 of 2008 regarding the appointment of the auditor by shareholders.

[144] IRBA is a body established in terms of s 3(1) of Act 26 of 2005 to regulate the auditing profession in South Africa. See ss 4–8 of Act 26 of 2005, which provide for the functions of IRBA.

[145] PIEs are defined in ss 290.25 to 290.26 of the amended IRBA Code of Professional Conduct for Registered Auditors as:

- all listed entities; and
- any entity defined by regulation or legislation as a public interest entity or for which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities.

Certain categories of entity may be treated as PIEs if they have a large number and wide range of stakeholders. Factors that should be considered include: the nature of the entity's business (such as the holding of assets in a fiduciary capacity for a large number of stakeholders – examples provided in the IRBA Code include financial institutions like banks, insurance companies and pension funds); size of the entity; and the number of employees of the entity.

[146] See IRBA Rule on Mandatory Audit Firm Rotation https://www.irba.co.za/upload/Government%20Gazette%20with%20Final%20Rule%20-%201%20June%202017.pdf (accessed 2017-09-24). See also s 10 of Act 26 of 2005, which empowers the IRBA to make rules.

Similarly, a network firm may not be re-appointed until after the expiry of the stipulated period of five financial years.

The primary underlying policy justification for the introduction of MAFR in South Africa is to enhance auditor independence from the audited client, thereby improving audit quality.[147] This, it is submitted, is a very sound policy consideration. It follows the IRBA's concerns, which included that the South African market is characterised by extended tenure of audit firms of over 100 years in some cases.[148] The other stated objectives of the MAFR rule, which the IRBA has categorised as secondary to the primary objective of enhancing auditor independence and audit quality, are: to provide more opportunities for small and mid-tier audit firms through increasing competition in the audit market, which has traditionally been dominated by the Big Four audit firms, and to promote transformation in the auditing profession.[149]

6 3 The effective date of the MAFR rule and determination of the time of rotation

The MAFR rule will apply to financial years beginning from 1 April 2023.[150] Therefore, all PIEs must comply with the MAFR rule from that date. Moreover, it appears from the wording of the rule that the calculation of the ten-year look-back period must be done retrospectively in two respects. First, the period during which a firm or a network firm has been serving as the appointed auditor of the PIE prior to 1 April 2023 will be taken into account when calculating the ten-year period required for rotation. Secondly, the period during which a firm or network firm served as the appointed auditor for an entity before such entity became a PIE will be included when calculating the timing for MAFR. It is imperative to emphasise that the period during which network firms are appointed as auditors of the PIE will be considered in determining the timing of audit firm rotation. This means that the period served by network firms will be included in the ten-year look-back period for audit firm rotation.

[147] IRBA "MAFR Gazetted to Enhance Auditor Independence and Protect Public Interest" (2 June 2017) https://www.irba.co.za/news-headlines/press-releases/mafr-gazetted-to-enhance-auditor-independence-and-protect-public-interest (accessed 2017-09-24); IRBA https://www.irba.co.za/upload/FAQ_%20MAFR%209%20June%202017.pdf 5 (accessed 2017-09-24).

[148] IRBA https://www.irba.co.za/news-headlines/press-releases/mafr-gazetted-to-enhance-auditor-independence-and-protect-public-interest (accessed 2017-09-24); IRBA "Frequently Asked Questions: Strengthening Auditor Independence to Enhance Public Investor Protection Through Mandatory Audit Firm Rotation (MAFR)" https://www.irba.co.za/upload/FAQ_%20MAFR%209%20June%202017.pdf 5–6 (accessed 2017-09-24).

[149] IRBA https://www.irba.co.za/news-headlines/press-releases/mafr-gazetted-to-enhance-auditor-independence-and-protect-public-interest (accessed 2017-09-24); IRBA https://www.irba.co.za/upload/FAQ_%20MAFR%209%20June%202017.pdf 5 (accessed 2017-09-24).

[150] IRBA https://www.irba.co.za/upload/Government%20Gazette%20with%20Final%20Rule%20-%201%20June%202017.pdf (accessed 2017-09-24); IRBA https://www.irba.co.za/news-headlines/press-releases/mafr-gazetted-to-enhance-auditor-independence-and-protect-public-interest (accessed 2017-09-24).

It is commendable that the regulator has given companies a period of about six years before the rule comes into operation. This is significant in at least two ways. First, it avoids sudden and major disruptions associated with the rushed implementation of a complex rule such as this one. This gives companies an opportunity to plan carefully and prepare in advance for the rotation so that it does not exacerbate the negative impacts of a rotation as discussed above. Secondly, it gives the regulator time to refine the rule before it is implemented. This is significant in view of the deficiencies in the rule that the author has identified as well as the recommendations that the author has provided on how the rule can be improved.

6 4 Transitional arrangements for the MAFR rule

The MAFR rule provides for transitional arrangements in the case of joint audits where the joint auditors have each had an audit tenure of ten years or more. In such a situation, the MAFR rule provides that only one audit firm must rotate at the effective date. The remaining audit firm is required to rotate after a further period of two years.[151] This is probably meant to prevent the undesirable situation of joint auditors having to rotate at the same time.

6 5 Inadequacies of the MAFR rule

Whereas the underlying policy objective of the MAFR rule to ensure auditor independence and objectivity is sound, the MAFR rule, as it currently stands, is superficial, has some flaws and is full of uncertainties. The potential application of the rule to private companies and all public companies (regardless of size and whether listed or non-listed) is out of line with the trend in other modern jurisdictions that have adopted MAFR. The onerous requirements associated with MAFR may not be suitable for smaller companies. It is submitted that careful thought should be given to the categories of company that should be exempted from MAFR requirements, with a particular focus on the size of companies. This includes small non-listed public companies.

Furthermore, like the Indian Companies Act 2013, the MAFR rule is too rigid in that it does not afford companies leeway to renew or extend audit firm tenure, even in exceptional circumstances. It is submitted that, in this regard, important lessons may be drawn from Article 17(8) of the EU Regulation, in terms of which it is possible to renew or extend an audit firm's tenure but subject to appropriate safeguards (as discussed above) to prevent potential abuse.

The MAFR rule is silent on the impact of an amalgamation or merger of companies on the application of the MAFR requirements. It is not clear, for example, in the case of a merger whether the period served by an audit firm as the appointed auditor of a constituent company (especially the "target" or "disappearing" company) would be considered when the same audit firm is appointed as auditor of the merged company.[152] It is submitted that the

[151] According to the MAFR rule, this provision will only be applicable at the effective date.

[152] See s 1 of Act 71 of 2008 regarding the definition of "amalgamation or merger" and Cassim "The Introduction of the Statutory Merger in South African Corporate Law: Majority Rule

period served as auditor of the disappearing company should be disregarded and only the period served as auditor of the merged company should be considered when determining the period for MAFR. In the context of an amalgamation, the MAFR rule is also silent on whether the period served by an audit firm as auditor of one of the constituent companies that have undergone an amalgamation would be considered when the audit firm is appointed as auditor of the amalgamated company. It is submitted that such period should not be taken into account as the amalgamated company is an entirely new entity. Moreover, the MAFR rule is silent on the impact of audit-firm amalgamations or mergers, acquisitions, or changes in ownership structure on MAFR. It is submitted that important lessons may be derived from Article 17(8) of the EU Regulation (as discussed above) in this regard.

The MAFR rule also does not address the situation where a company has joint auditors that have been appointed simultaneously subsequent to the commencement of the MAFR rule. The transitional provisions allow a company that has joint auditors to retain one of the auditors for a further period of two years after the expiry of the prescribed ten-year period for MAFR. However, the MAFR rule clearly provides that this flexibility will not apply after the effective date. In view of this, companies will essentially be compelled to ensure that the appointment and rotation of joint auditors after the effective date of the MAFR rule is staggered so that joint auditors will not be required to rotate at the same time.

Furthermore, the MAFR rule does not address the situation where there is a break in the firm's audit tenure before the expiry of the ten-year period. For example, there may be a break in the audit tenure after the audit firm has audited the same company for nine consecutive years. The rule should specify whether such a break would be treated as a rotation, with the consequence that the five-year cooling-off period would apply before the audit firm could be re-appointed as auditor of that company.

Another weakness in the MAFR rule is that it does not place a positive duty on auditors or PIEs to report an audit firm's tenure and information on its rotation. This issue is addressed by a separate rule published by IRBA on 4 December 2015 requiring the auditor's report on the annual financial statements to specify the number of years that the audit firm or sole practitioner (as the case may be) has been the auditor of the entity.[153] Disclosure of such information promotes transparency and accountability. In addition, the MAFR rule does not provide for any direct and sufficiently deterrent penalties for audit firms and individual audit partners who contravene MAFR requirements.

7 RECOMMENDATIONS FOR SOUTH AFRICA

In this part, the author first presents proposals for the reform of the law in regard to MAPR before proceeding to present proposals for the further

Offset by the Appraisal Right (Part 1)" 2008 20 *SA Merc LJ* 1 2–6, regarding the definition and effect of a merger.

[153] IRBA "Strengthening auditor independence by making disclosure of audit tenure mandatory" (4 December 2015) https://www.gov.za/sites/default/files/gcis_document/201512/39475bn138.pdf (accessed 2017-09-28).

development and refinement of the MAFR rule. The discussion above has revealed that the provisions of section 92 of the Companies Act[154] concerning MAPR are, to a considerable extent, in line with international trends. However, these provisions also have certain identifiable shortcomings, including lack of transparency requirements and lack of appropriate flexibility. It is submitted that South Africa should borrow certain positive features of the statutory provisions developed in the EU, India and Australia (as discussed above) to strengthen the existing provisions of the Companies Act. In relation to MAPR, the following recommendations are made:

- The Companies Act should continue to regulate MAPR notwithstanding the introduction of MAFR into South African law. In other words, MAPR should not be replaced by MAFR. These two forms of mandatory auditor rotation should continue to exist alongside each other, as is the case in the EU and India, because they are complementary to each other.
- The legislature should consider whether the current cooling-off period of two financial years is sufficient to allow an audit partner to regain his or her independence and objectivity. There is scope to increase this cooling-off period to three years, as is the case in the EU, or to five years, as is the case in India.
- The Companies Act should provide for companies to be able to extend an audit partner's tenure in exceptional circumstances, as is the case in Australia and India. This would help avoid undue disruptions caused by implementing a rotation – for example, in the midst of corporate restructuring exercises. This should, however, be subject to adequate safeguards as in Australia. It is suggested that the board of directors should approve the extension and that the extension should be in accordance with a recommendation by the audit committee. The company should be required to provide reasons to satisfy the audit committee that granting the extension is consistent with maintaining audit quality and would not lead to a conflict of interest situation.
- The Companies Act should impose a positive duty on companies to report to shareholders the audit partner's tenure and information regarding the audit partner's rotation. This would promote transparency and accountability, and enable shareholders to cast their vote on the resolution to appoint or re-appoint the auditor in an informed manner.
- The Companies Act should provide for direct and strict penalties on audit firms and individual audit partners who contravene the requirements on MAPR, as is the case in Australia. This would ensure adherence to the statutory requirements that seek to promote auditor independence, transparency and audit quality.

The discussion above has further revealed that the recently promulgated MAFR rule is not well developed to deal with the complexities associated with MAFR. It is submitted that regulators in South Africa should take into account legislative provisions developed in jurisdictions such as the EU and India as well as the arguments advanced against MAFR across the

[154] Act 71 of 2008.

jurisdictions discussed above to further develop and refine the MAFR rule. The following recommendations are, therefore, made in relation to MAFR:

- MAFR should be regulated by the Companies Act, as is currently the case with MAPR. This would be in line with the approach in India where MAPR is regulated in the Companies Act 2013. The Companies Act is the main piece of legislation regulating companies in South Africa. Accordingly, regulating MAFR within the Companies Act would ensure consistency, principle and harmony in the regulation of companies in South Africa.
- The legislature should consider exempting smaller non-listed public companies from compliance with MAFR requirements. The experience in the EU and India shows that the onerous MAFR requirements may not be suitable to all companies. The Companies Act already distinguishes between certain categories of company insofar as compliance with its provisions for enhanced transparency and accountability in Chapter 3 of the Act is concerned. For example, smaller private companies are not obliged to appoint an auditor to audit their annual financial statements. In the same vein, it is submitted that smaller public companies that do not meet certain criteria to be set by the legislature, taking into account the size as well as the economic and societal impact of such companies, should be exempted from MAFR requirements.
- There should be specific and clear provisions to regulate MAFR where a company has joint auditors that have been appointed simultaneously subsequent to the commencement of the MAFR rule.
- There should be specific provisions to enable companies to renew an audit firm’s tenure, as is the case under the EU Regulation. This would help avoid undue disruptions caused by implementing a rotation. This should, however, be subject to adequate safeguards as in the EU – namely, that the renewal must have been recommended by the audit committee, or the administrative or supervisory body, and that the renewal must be approved by a resolution of the shareholders at a general meeting. The renewal of an audit firm’s tenure would also be appropriate where a tender has been conducted. Any renewal of an audit firm’s engagement should be possible only once. Thereafter, the audit firm must rotate.
- Specific provisions should be enacted to enable companies to extend an audit firm’s tenure by a limited number of years in exceptional circumstances, as is the case under the EU Regulation. This would help avoid undue disruptions caused by implementing a rotation – for example, in the midst of corporate restructuring exercises such as amalgamations or mergers, schemes of arrangement and other fundamental transactions. Permission for an extension should be sought from the Companies and Intellectual Property Commission (as the administrative or supervisory body), which should be given leeway to determine what would constitute exceptional circumstances on a case-by-case basis.
- Specific provisions should be enacted to address adequately the implications for MAFR of corporate actions such as amalgamations or mergers and acquisitions between or among companies.

- There should also be specific provisions to address adequately the implications for MAFR of amalgamations or mergers and acquisitions between, or among, audit firms.
- Mandatory tendering should be provided for as an alternative to MAFR. However, in such a case, if the same audit firm is appointed for two consecutive periods of ten years, it is submitted that the same firm should not be re-appointed to audit the same company during the following financial year until a cooling-off period of five years has lapsed.
- There should be specific provisions that adequately address a situation where there is a break in an audit firm's tenure before the expiry of the prescribed ten-year term. It is submitted that section 92(2) of the Companies Act, dealing with MAPR, may provide useful guidance in this regard. For example, a break in audit tenure after an audit firm has been appointed for seven or more consecutive financial years may be deemed to be a rotation, with the consequence that the five-year cooling-off period would apply.
- As is the case with MAPR, MAFR requirements should not take away the company's existing right to remove an auditor or the auditor's right to resign as auditor of the company.
- A positive duty should be imposed on companies to report the audit firm's tenure and information regarding the audit firm's rotation to shareholders. This would promote transparency and accountability. It would also enable shareholders to cast their votes on the resolution to appoint or re-appoint the auditor in an informed manner.
- The Companies Act should provide for direct and strict penalties on audit firms and companies that contravene the requirements on MAFR in order to ensure compliance with MAFR requirements.

8 CONCLUSION

The statutory audit of companies is essential to the protection of companies, shareholders, prospective investors, the capital markets and other participants in the capital markets. For this reason, statutory auditors are frequently viewed as performing a public function and are, as such, expected to act in the public interest. The past few years have been characterised by an increased global and local focus on auditor independence and objectivity as a result of a general decrease in audit quality as well as certain high-profile audit failures. Auditor independence is viewed as an important tool for preventing audit failure and for ensuring audit quality. In addition to the fundamental structural weakness in the appointment of an external auditor and in the relationship between auditor and company, auditor independence (both actual independence and independence in appearance) may be impaired by extended auditor tenure. Extended auditor tenure is, in turn, caused by a lack of audit firm or audit partner rotation. Such lack of rotation may lead to auditor entrenchment and over-familiarity with the audited company, and may further exert undue pressure on the auditor to maintain a long relationship with the audited company. Mandatory rotation of auditors, in the form of MAPR and/or MAFR, is one route adopted by regulators in various jurisdictions in a bid to enhance auditor independence and objectivity.

In this article, having analysed the significance of the external auditor in capital markets and the value of auditor independence and objectivity, the author submits that the regulation of mandatory rotation of auditors as a strategy for reinforcing auditor independence and audit quality is both desirable and necessary in the South African market. The author has, therefore, examined the adequacy of the current provisions of section 92 of the Companies Act,[155] and the recently promulgated MAFR rule, in regulating mandatory auditor rotation in South Africa in light of legislative developments in the US, Canada, the EU, Australia and India. It is submitted that the current provisions on MAPR in the Companies Act are generally in line with international trends. However, these provisions have certain identifiable flaws when compared to features of equivalent provisions in some international jurisdictions considered in this article – for example, they are inflexible in certain instances and fail to adequately promote auditor transparency and accountability. It has been demonstrated how certain positive features of legislative provisions in the EU, Australia and India could be considered and, with the necessary adaptations, introduced into the Companies Act in order to strengthen the existing MAPR requirements.

Even though the recently promulgated MAFR rule is welcome, it is currently not well developed to deal with the complexities associated with MAFR. It is submitted that lawmakers in South Africa should take into account legislative provisions developed in jurisdictions such as the EU and India as well as the arguments advanced against MAFR across jurisdictions discussed in this article to further develop and refine the MAFR rule. Market players should also come up with innovative ways of navigating the potential obstacles associated with MAFR in practice whilst maximising the benefits of MAFR. It is submitted that the recommendations made in this article are in line with the fundamental objectives of the Companies Act, as set out in section 7, which include: creating flexibility and simplicity in the formation and maintenance of companies; encouraging transparency and high standards of corporate governance; promoting investment in the South African markets; and providing for predictability and efficiency in the regulation of companies.

[155] Act 71 of 2008.