

RE-THINKING MANDATORY AUDITOR ROTATION: A COMPARATIVE ANALYSIS

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SUMMARY

Since formation of the European Union, there has been a worldwide upsurge in regulation of the auditing profession, which has included mandatory auditor rotation and this has also found its way into South African company law, regardless of the many arguments against it. The number of corporate scandals or company failures justifies an evaluation of the effectiveness of such regulation and a re-thinking of the concept of auditor rotation. Revisiting the arguments against and in favour of mandatory auditor rotation confirms the rational arguments against mandatory auditor rotation. These arguments are opposed to the main reason for its implementation – namely, that rotation will serve as a publicly acceptable band-aid on damaged investor confidence. Overshadowed by corporate scandals, regulators face constant pressure to enhance auditors' independence and to amend and improve regulations. To inform the South African stance, developments regarding auditor rotation in Germany and Australia are examined. An assessment of the significance of mandatory auditor rotation in the current corporate-law environment reveals that Steinhoff (Steinhoff International Holdings N.V.) failed in 2018, despite the fact that auditor-rotation legislation was in place. This supports arguments against auditor rotation and suggests that South Africa too hastily followed international trends. Mandatory auditor rotation regulations in South Africa also discourage potential candidates from entering the auditing work environment. It is submitted that the current provisions do not contribute effectively to auditor independence and are merely desperate attempts to curb the public's lack of confidence in the auditing profession. Section 92 of the Companies Act 71 of 2008, dealing with mandatory auditor rotation, should therefore be repealed.

1 INTRODUCTION

Mandatory rotation of company auditors found its way into South African company law when the legislator passed the Companies Act (2008 Companies Act).¹ Mandatory rotation was introduced under ministerial pressure and over-eagerly following the international trend, despite the many arguments against rotation of auditors.² Part C of the 2008 Companies Act

¹ S 92 of the Companies Act 71 of 2008.

² Odendaal *Regulering van die Ouditeursprofessie in Suid-Afrika* (DCom (Accounting) thesis, University of Pretoria) 2006 102; Schoeman *The Role and Liability of Auditors in Corporate Disclosures and Reporting: A Legal Analysis* (LLD thesis, University of Pretoria) 2022 160.

codifies the specific obligations concerning the appointment of auditors,³ their resignation, the occurrence of vacancies,⁴ the rotation of auditors⁵ and the rights and limited functions of auditors for public and state-owned companies.⁶ The same company auditor may only serve in this role for five consecutive financial years; and in the event that a company auditor ceases to serve the company after two or more consecutive financial years, such auditor may not be appointed again until after the expiry of not less than two further financial years.⁷

After formation of the European Union, there was an upsurge in co-ordination of accounting rules, regulation of the publication of annual accounts, rules pertaining to the audit of such accounts and other requirements with which an auditor has to comply.⁸ Many directives soon followed, with the aim of regulating the auditing profession; more rules were instituted to regulate, among other aspects, access to the profession, professional competence, independence and impartiality, international accounting standards, public oversight, the institution of audit committees for public-interest entities and transparency reports, as well as auditor rotation.⁹ Mandatory rotation of auditors was instituted for listed companies in Italy in 1975, and the results have been generally progressive, enhancing auditor independence.¹⁰ The Sarbanes-Oxley Act of 2002 in the United States of America (USA) engendered rules such as mandatory audit-partner rotation based on European rules,¹¹ and South Africa followed this international trend under ministerial pressure during 2002.¹²

Despite the institution of mandatory rotation of company auditors, corporate scandals and company failures were not avoided – as evidenced by, among others, Steinhoff and VBS Mutual Bank. Although Klynveld, Peat, Marwick and Goerdeler (KPMG) were appointed as auditors of VBS Mutual Bank in 2017, certain inaccuracies in the 2016 financial statements were not reported and major fraud was committed within two years, notwithstanding the risk of being exposed by auditors to be appointed in future.¹³ PricewaterhouseCoopers Advisory Service Proprietary Limited identified in the financial statements of Steinhoff irregular transactions that were

³ S 90 of the 2008 Companies Act.

⁴ S 91 of the 2008 Companies Act.

⁵ S 92 of the 2008 Companies Act.

⁶ S 93 of the 2008 Companies Act.

⁷ S 92(1) and (2) of the 2008 Companies Act; Blythe “The In Pari Delicto Defense for Auditors in Professional Negligence Cases: Imputation of Managers’ Unlawful Acts to the Client Firm” 2015 5(2) *Accounting Economics and Law: A Convivium* 192 196 n 1.

⁸ Conac, Enriques and Gelter “Constraining Dominant Shareholders’ Self-Dealing: The Legal Framework in France, Germany, and Italy” 2007 4(4) *European Company and Financial Law Review* 491 505.

⁹ Van der Zanden and Van der Zanden “A Description of the Historical Developments in Standard Setting and Regulations for Auditors and the Audit Firms in an International Perspective” 2013 *Dovens Schmidt Quarterly* 89 91–92.

¹⁰ Mark “Accounting Fraud: Pleading Scienter of Auditors Under the PSLRA” 2007 *Connecticut Law Review* 1097 1201.

¹¹ Painter “Convergence and Competition in Rules Governing Lawyers and Auditors” 2004 *Journal of Corporation Law* 397 398.

¹² Odendaal *Regulering van die Ouditeursprofessie in Suid-Afrika* 102.

¹³ Motau *VBS Mutual Bank: The Great Bank Heist – Investigator’s Report to the Prudential Authority* (2018).

performed over a number of years;¹⁴ these had not been reported by the audit firm Deloitte Touche Tohmatsu before the collapse of Steinhoff's share price after the disclosure of accounting irregularities.¹⁵ This justifies a reconsideration of the significance of mandatory auditor rotation. Questionable interactions between directors and auditors incentivise the implementation of mandatory auditor rotation, but the continuous contemptible state of affairs in corporate governance calls for an evaluation of the effectiveness of such regulation and ultimately a re-thinking of the concept.

2 REVISITING THE ARGUMENTS FOR AND AGAINST MANDATORY AUDITOR ROTATION

A study of mandatory periodic audit-firm rotation in Italian companies by Milan's Bocconi University found a multitude of benefits, of which the most important is the worthiness of the audit practice for the purpose of restoring critically damaged investor confidence in the financial accounting system.¹⁶ Healey and Kim acknowledge numerous justified arguments against mandatory auditor rotation, but aver that they cannot be compared to these benefits.¹⁷ The unique character of the Italian corporate governance structure should, however, be kept in mind, since most companies are family-owned and -controlled, with infuriating agency problems and conflicts among shareholder groups, which allow for active participation of internal auditors in corporate governance matters.¹⁸

Particular public benefits may be divided among three general areas of auditor rotation – namely, the establishment of a peer-review process to deter aggressive accounting practices and promote acute reviews upon turnover of each auditor; the avoidance of conflicts of interest that may evolve from an enduring client relationship; and, finally, the promotion of an enlarged competitive market for audit firms resulting in improved quality of audits.¹⁹ It is further proposed that mandatory rotation may relieve audit firms from the ever-increasing burden of separating non-audit business from audit services and from constantly observing audit partners in engagements with their public-company clients.²⁰

On the other hand, high engagement costs, and a contraction in audit quality occasioned by the disturbance of the ongoing relationship that normally affords comprehensive knowledge of the nature and operations of

¹⁴ Buthelezi "Deloitte Accuses Irba's Investigator of Bias in African Bank Probe" (10 December 2018) <https://www.businesslive.co.za/bd/companies/financial-services/2018-12-10-deloitte-accuses-irbas-investigator-of-bias-in-african-bank-probe/> (accessed 2022-11-10).

¹⁵ PWC Advisory Service (Pty) Ltd "Steinhoff's 2019 Overview of Forensic Investigation" <https://docs.google.com/viewerng/viewer?url=https://cdn.24.co.za/files/Cms/General/d/8637/28d45d9efd9e477d8dd8ff4f9ad6709c.pdf> 2 (accessed 2019-10-04).

¹⁶ Healey and Kim "The Benefits of Mandatory Auditor Rotation" 2003 *Regulation* 10 10.

¹⁷ Healey and Kim 2003 *Regulation* 10 10.

¹⁸ Vadasi, Bekiaris and Andrikopoulos "Corporate Governance and Internal Audit: An Institutional Theory Perspective" 2019 *Emerald Publishing Limited* 1 1.

¹⁹ Healey and Kim 2003 *Regulation* 10 10–11.

²⁰ Healey and Kim 2003 *Regulation* 10 10.

the business, are listed as possible reasons against auditor rotation.²¹ The drawbacks and expenditures associated with poor-quality audits are far greater than the probable costs of auditor rotation; and enhanced governance can prevent misrepresentation of public-company performance, which has been the economic justification for tolerating the increased costs of auditor rotation.²² The fact that a new auditor has to familiarise themselves with the organisation afresh on each rotational turn tends to demonstrate that auditor rotation would not impact positively on audits; rather, it is probable that the opposite is true, measured against the astronomical costs of tender proceedings and the enormous practical and operational bearing these have. All these factors may undoubtedly escalate the potential for failure by the new auditor to discover material misstatements.²³ Rotating the audit firm, and not simply the audit partner, would more effectively serve the purpose of the process, while the dedication of time and money associated with such change would then at best be justified; a different partner from the same audit firm would in any event be hesitant to condemn his or her colleagues.²⁴

The absence of rotation has hypothetically severely harmful effects, as illustrated in the USA scandals of Enron, WorldCom and HealthSouth, where the auditors had been hired for longer than 10 years at the time the scandals occurred. There is a powerful enticement to verify a client's accounting decisions, including fraudulent accounting, when an audit firm is aware that its client will proceed to engage their services for the foreseeable future, as long as the firm remains favourably viewed by management. By the same token, an individual auditor may be prompted to approve indecorous accounting when mindful of the probability of being offered a top management position with his or her client.²⁵ The auditor's role can thus be negated, rendering him or her to be nothing more than a puppet in the hands of management.

In the USA, auditor rotation was opposed publicly for many years by the auditing industry, based on the argument that the costs of auditing would escalate should corporations be compelled to adhere to rotation. As indicated, however, the loss of investor confidence owing to incorrect or fraudulent financial statements probably will be a more serious problem than increased audit costs.²⁶

McKinnon criticises the arguments in favour of a rotation system; aiming to increase audit quality by ending the relationship between a company and its auditor is an "unsound" presumption, since studies show that audit quality improves over an auditor's tenancy with a particular client, and that audit failures around detecting accounting irregularities increase notably owing to the new auditor's lack of acquaintance with a particular client.²⁷ Secondly,

²¹ Healey and Kim 2003 *Regulation* 10 11.

²² Healey and Kim 2003 *Regulation* 10 11.

²³ Van der Zanden and Van der Zanden 2013 *Dovens Schmidt Quarterly* 89 103.

²⁴ Krackhardt "New Rules for Corporate Governance in the United States and Germany: A Model for New Zealand" 2005 *Victoria University of Wellington Law Review* 319 336.

²⁵ Mark 2007 *Connecticut Law Review* 1097 1197.

²⁶ Mark 2007 *Connecticut Law Review* 1097 1201.

²⁷ McKinnon "Auditing the Auditors: Antitrust Concerns in the Large Company Auditing Market" 2015 *New York University Journal of Law and Business* 533 561.

rotation might not decrease concentration, since large companies will simply obtain the services of another large audit firm; in fact, this may, in the short term, aggravate the concentration problem, not to mention incur astronomical costs.²⁸

In response to the regulator's presumption that auditor rotation will help alleviate complications of agency and rational favouritisms that impede audit quality, Painter warns that there is no assurance that these rules actually improve the reaction of auditors towards risk, while the degree to which these rules tarnish the movement of information from the audit client to the auditor has not been established. In light of empirical evidence indicating that the extent of an audit client's earning accruals is inversely related to the length of the auditor-client relationship, he proposes that mandatory auditor rotation in fact may have a disadvantageous effect on audit quality.²⁹

A completely divergent opinion holds that the character of the free-market auditing industry is irreconcilable with the objective of auditor independence. This approach concludes, on the basis of a revision of the status of the modern financial auditing industry, that neither the Sarbanes-Oxley Act, nor any other endeavour by the legislator, nor anything short of a comprehensive overhaul of the financial audit industry, will do away with the impediments faced by auditor independence.³⁰ This suggests a government audit scheme that will transform the existing method of auditor compensation by introducing a mandatory, pre-determined audit fee structure that will remove anxieties of auditors that their remuneration hinges on their ability to satisfy the management of a company.³¹ The "at-will relationship" between auditors and their clients would be replaced with mandatory audits that give no choice on which audit company will perform the audit, nor what the scope of the audit will be, since all audits would be conducted by government auditors. Finally, all competition would be eliminated, and auditors would be afforded the opportunity to work undisturbed – not dreading the termination of their engagement.³² It is however doubted that a free market would assent to these propositions. Nonetheless, aspects of the suggested fee structure may be of benefit in resolving the controversy about the upsurge in fees earned for non-audit services.³³

Kleinman, Anandarajan and Palmon quote the Public Company Accounting Oversight Board's remark that mandatory rotation will prevent audit firms from turning every new engagement into a long-term revenue stream, thereby fundamentally altering the firm's relationship with its audit client. This could meaningfully improve the auditor's role when it comes to its function "as an independent gatekeeper".³⁴ Rotation may enhance the independence of auditors by lessening their collusion, which usually stems

²⁸ McKinnon 2015 *New York University Journal of Law and Business* 533 561–562.

²⁹ Painter 2004 *Journal of Corporation Law* 397 418.

³⁰ Klimentchenko "Myth of Auditor Independence" 2009 *University of Illinois Law Review* 1275 1276.

³¹ Klimentchenko 2009 *University of Illinois Law Review* 1275 1276.

³² Klimentchenko 2009 *University of Illinois Law Review* 1275 1298–1299.

³³ Schoeman *The Role and Liability of Auditors* 133.

³⁴ Kleinman, Anandarajan and Palmon "Who's to Judge? Understanding Issues of Auditor Independence vis à vis Judicial Independence" 2012 2(1) *Accounting Economics and Law: Convivium* 23.

from ongoing professional and occasionally personal relationships; and it may have a constraining effect, given that an auditor's services will in future be reviewed by a new rotation auditor, who may discover the previous auditor's complicity in fraud.³⁵

3 EFFECTIVENESS OF MANDATORY AUDITOR ROTATION

In South Africa, mandatory auditor rotation regulations are listed as causes that contribute to a less appealing general work environment for auditors.³⁶ In 2007, Bourne voiced the opinion that the USA's Sarbanes-Oxley Act and the South African Corporate Laws Amendment Act 24 of 2006 had enhanced auditor independence by prescribing an improved degree of separation between auditor and client.³⁷ It was done by introducing measures such as audit committees and auditor rotation, as well as constraints around the provision of non-audit services by an auditor to its client, in light of the generally accepted view that regulations are fundamental to ensuring that auditors maintain an objective and impartial role.³⁸ Though Bourne's opinion might have been sustainable in 2007, it will certainly be questioned today in the face of recent audit and accounting scandals in South Africa, as listed above.

3.1 Independence issues

In addition to all the regulations contained in the Auditing Profession Act,³⁹ and in the same vein as for directors, Part C of the 2008 Companies Act contains specific codifications regarding the appointment, resignation, vacancies, rotation, rights and limited functions of auditors for public and state-owned companies that are, as such, obliged to appoint an auditor on an annual basis.⁴⁰ Only registered auditors who are not disqualified in terms of section 69(8) of the 2008 Companies Act to serve as a director, and who are not a director or prescribed officer of the company, may be appointed for this audit. Section 90(2) includes a further list of persons who may also not serve as auditors of the company.⁴¹ The position of the company auditor is

³⁵ Ferreira-Gomes "Auditors as Gatekeepers: The European Reform of Auditors' Legal Regime and the American Influence" 2005 *Columbia Journal of European Law* 665 683.

³⁶ Harber "Exploring the Nature and Consequences of a Possible Decline in the Appeal of the South African Audit Profession" 2018 *SAJAAR* 13 15.

³⁷ Bourne "Auditor Independence: An Analysis of the Legislation in the United States of America and South Africa" 2007 *SAMLJ* 492 501.

³⁸ Bourne 2007 *SAMLJ* 501.

³⁹ 26 of 2005.

⁴⁰ Ss 90–93 of the 2008 Companies Act. In terms of s 90(3), companies may appoint a firm as an auditor, and an individual determined by such firm according to the provisions of s 44(1) of the APA will then be responsible for performing the functions of the company auditor. S 90(3) and (4) determine that if companies that are required to appoint an auditor fail to do so when incorporating a company, then the directors of such company must appoint the first auditor within 40 business days after the date of incorporation, and such auditor holds office as company auditor until the conclusion of the first annual general meeting of the company.

⁴¹ S 90(2)(b) further excludes the following persons to serve as auditors of a company.

regulated in a manner to ensure that a company has an auditor on a permanent basis who, should a vacancy arise, is replaced immediately.⁴²

Overshadowed by corporate scandals, regulators are under continued pressure to enhance auditors' independence, forcing them constantly to amend and improve regulations. With a view to conforming amendments to the International Auditing and Assurance Standards Board (IAASB) International Standards,⁴³ the revised International Ethics Standards Board for Accountants (IESBA) Code International Standards on Quality Control (ISQC) 1 Paragraph A14 and Paragraph 25 were amended. A change was made to recognition of the familiarity threat, which is predominantly relevant in the context of financial statement audits of listed entities that require the rotation of the key audit partner. Now a straightforward requirement obliges the rotation of the engagement partner, the engagement quality control reviewer and other key audit partners.⁴⁴

ISQC 1 now provides that the policies and procedures of a firm must stipulate the criteria for establishing the necessity to remove the circumstances "that create a threat of long association with an entity to an acceptable level ... or criteria for applying safeguards to reduce the threat".⁴⁵ Mandatory auditor rotation has also been suggested as a way to ease the

- "(ii) an employee or consultant of the company who was or has been engaged for more than one year in the maintenance of any of the company's financial records or the preparation of any of its financial statements;
- (iii) a director, officer or employee of a person appointed as company secretary in terms of Part B of this Chapter;
- (iv) a person who, alone or with a partner or employees, habitually or regularly performs the duties of accountant or bookkeeper, or performs related secretarial work, for the company;
- (v) a person who, at any time during the five financial years immediately preceding the date of appointment, was a person contemplated in any of subparagraphs (i) to (iv); or
- (vi) a person related to a person contemplated in subparagraphs (i) to (v)."

Section 90(2)(c) requires that the person:

"(c) must be acceptable to the company's audit committee as being independent of the company, having regard to the matters enumerated in section 94(8), in the case of a company that has appointed an audit committee, whether as required by section 94, or voluntarily as contemplated in section 34(2)."

⁴² S 91 stipulated that when a vacancy arises in the office of the only auditor of a company, the board of directors must fill the vacant position within 40 business days. The board must within 15 business days from the vacancy propose to the audit committee, a name of at least one registered auditor for consideration for appointment as the new auditor and proceed within 5 business days after delivering the proposal if the audit committee does not give written notice rejecting the proposed auditor.

⁴³ In April 2020, the IAASB International Standards was amended to conform with the revised IESBA Code by stipulating in ISQC 1 Paragraph A8 of the IESBA Code: "The IESBA Code provides a conceptual framework that establishes the approach which a professional accountant is required to apply when identifying, evaluating and addressing threats to compliance with the fundamental principles. In the case of audits, reviews and other assurance engagements, the IESBA Code sets out International Independence Standards, established by the application of the conceptual framework to threats to independence in relation to those engagements."

⁴⁴ IAASB's Final Pronouncement April 2020 10.

⁴⁵ IAASB's Final Pronouncement April 2020 7.

problem of large-firm concentration.⁴⁶ Although the values of mandatory rotation are frequently praised, history indicates that large corporations will not by choice select another audit firm outside of the Big Four audit firms.⁴⁷

Where auditor rotation did not occur, a revolving-door hiring phenomenon ensued, and the independence that auditors were required to demonstrate was attenuated for the reason that, in such circumstances, they are inclined to enjoy favouritism from management. This appeared to be the order of the day during 2003, when 99 per cent of Fortune 1000 public companies and their audit committees did not have any audit-firm rotation policy in place.⁴⁸

The Sarbanes-Oxley Act failed to resolve the auditor-rotation predicament, since audit firms were only required to rotate the lead and concurring review partners within a specific audit firm every five years. This regulation was rightly criticised as having had little or no effect at all, as it failed to diminish the financial temptation for auditors to attenuate their judgment on accounting issues. It might in fact have intensified the predicament to the extent that partners in large audit firms would compete against each other for a promotion and bonus.⁴⁹

3 2 Auditor rotation in Germany and Australia

3 2 1 Germany

Distinctive historic events influenced the evolution of German businesses, resulting in a particular trait of German corporate law – namely, the concept of co-determination (*Mitbestimmung*).⁵⁰ Labour law and corporations law are therefore connected by several statutory provisions that regulate the rights and duties of employee representatives on supervisory boards and the rules relating to collective bargaining.⁵¹ Co-determination legislation distinguishes German supervisory boards of publicly traded companies in terms of the perspective of shareholders and employees.⁵²

⁴⁶ McKinnon 2015 *New York University Journal of Law and Business* 533 559.

⁴⁷ McKinnon 2015 *New York University Journal of Law and Business* 533 561.

⁴⁸ Mark 2007 *Connecticut Law Review* 1097 1196–1197. Because mandatory rotation was not compulsory at that time, audit relationships naturally continued for a long time, averaging 22 years between the Fortune 1000 companies and their auditors. By 2006, at least 18 large companies in the USA, such as General Electric, Phelps Dodge, General Motors, Caterpillar, Boeing and Walt Disney had enjoyed audit relationships with the Big Four auditor firms for longer than 50 years.

⁴⁹ Mark 2007 *Connecticut Law Review* 1097 1199.

⁵⁰ Du Plessis, Großfeld, Luttermann, Saenger, Sandrock and Casper *German Corporate Governance in International and European Context* (2012) 2.

⁵¹ Du Plessis *et al German Corporate Governance in International and European Context* 2; see also Botha *Employee Participation and Voice in Companies: A Legal Perspective* (LLD thesis, North-West University) 2015 288–369 for a comparative discussion of Germany, the EU and SA regarding board structures and co-determination.

⁵² Amanbaeva *The Monitoring Role of Outside Directors and Supervisory Boards in One-Tier and Two-Tier Board Models in Public Companies in the USA and Germany* (BA (Hons) Commercial Law dissertation, Westminster International University in Tashkent) 2015 19.

Large industrial companies usually use public companies (*Aktiengesellschaft*)⁵³ with the usual two-tier board structure, while smaller companies use private or proprietary companies (*Gesellschaft mit beschränkter Haftung*).⁵⁴ German corporate law is typified by a two-tier board system that consists of a managing board (*Vorstand*) and supervisory board (*Aufsichtsrat*).⁵⁵ The supervisory board is elected at the general shareholder meeting and half of the members comprise employee representatives who give effect to the German system of co-determination; however, the chairperson, who has a casting vote, is elected by the shareholders, which means that the board can be branded as taking a “quasi-parity” form.⁵⁶ German corporations law is influenced by international debates on important corporate-law issues, while corporate-governance discussions are precipitated by International Financial Reporting Standards (IFRS), the introduction of rating agencies and new evaluation techniques. The private-law classification of corporations law (the regulation of specifically large public corporations) is nevertheless founded on precise and accurate statutory provisions.⁵⁷

In the absence of corporate scandals comparable to the Enron disaster in the USA, and given the general opinion that German corporate governance functioned well, the development of the 2002 German Corporate Governance Code was inspired by a decision to entice international investors to surmount the economic crisis.⁵⁸ It was, however, difficult for investors from the USA to identify with the German corporate-governance system, which differs considerably from theirs.⁵⁹ To overcome difficulties (including the two-tier board, an absence of transparency, less emphasis on shareholder interest, lack of independence for supervisory boards and lessened independence of auditors), the German government embraced a

⁵³ Du Plessis *et al* (*German Corporate Governance in International and European Context*) explain the *Aktiengesellschaft* company as follows: *Aktiengesellschaft* (AG) is often translated as “joint stock corporation”. The use of the term “joint stock company/corporation” or “joint-stock company/corporation” was common when the various Joint Stock Companies Acts were passed in the 1800s in England, but the term was used long before that. This is also reflected in the titles of some of the leading textbooks of the 1800s. However, nowadays in the USA, the UK and other Anglo-American jurisdictions, the trend is to refer to companies or corporations comparable to the *Aktiengesellschaft* (AG) simply as “public companies or corporations”; “publicly-traded companies or corporations”; “public companies or corporations limited by shares”; or “public limited companies or corporations”.

⁵⁴ Du Plessis *et al* (*German Corporate Governance in International and European Context* 6) describe the *Gesellschaft mit beschränkter Haftung* company (GmbH) as being comparable to the private or proprietary company. See also Van der Zanden and Van der Zanden 2013 *Dovenschmidt Quarterly* 89–90.

⁵⁵ Krackhardt 2005 *Victoria University of Wellington Law Review* 319–323–324; Botha “Evaluating the Social and Ethics Committee: Is Labour the Missing Link? (Part 2)” 2017 *THRHR* 15.

⁵⁶ Botha 2017 *THRHR* 15.

⁵⁷ Botha 2017 *THRHR* 3.

⁵⁸ For a comprehensive discussion of the influence of the convergence of corporate governance systems, see Hassel and Beyer “The Effects of Convergence: Internationalisation and the Changing Distribution of Net Value Added in Large German Firms” *Max Planck Institut für Gesellschaftsforschung Discussion Paper No 01/7* (2001) 1–29.

⁵⁹ Hassel and Beyer *Effects of Convergence* 1–29.

more transparent and accessible conception of the German system.⁶⁰ Without adding many new rules to the German Corporate Governance Code, the code mainly reflects the foundation of German corporate law, with the purpose of recapping and clarifying the German system, emphasising in particular co-determination and the two-tier board structure.⁶¹ Interestingly, there is no prescription as to rotation of auditors in German law.⁶² The German Corporate Governance Code requires that the supervisory board appoint an auditor and agree on his or her fees, while the auditor has to partake in all the supervisory board meetings relating to financial statements.⁶³ Only two new duties for auditors were recently introduced – namely, that they must declare any prior relations with the company or its directors that affect the company's independence around their selection, possibly causing a conflict of interests;⁶⁴ and secondly, recent or actual contracts, in particular consulting engagements and future contracts for the ensuing year, must be disclosed.⁶⁵ If similar conflicts of interest arise after the auditor's appointment, then the auditor must notify the supervisory board without delay.⁶⁶ A second, similar duty ensues when an auditor discovers any facts that may adversely affect the affairs of the supervisory board.⁶⁷

Although the German corporate-governance system appears to differ from the South African corporate-governance system since it involves a two-tier board and co-determination, it may be argued that there are similarities; in South Africa, the social and ethics committee functions as a distinct organ of a company and is therefore not a board committee⁶⁸ – hence, the proposition that the social and ethics committee can act as a division that results in a two-tier board in South Africa, and that workplace forums in the Labour Relations Act achieve similar outcomes to co-determination.⁶⁹ Valuable lessons can be learnt from German corporate governance regarding the absence of rotation of auditors and the manner in which auditor independence is regulated.

3.2.2 Australia

Mandatory rotation of only the key audit partner is required.⁷⁰ Following the German trend, the Parliamentary Joint Committee on Corporations and Financial Services thoroughly investigated whether mandatory auditor

⁶⁰ Hassel and Beyer *Effects of Convergence* 1–29.

⁶¹ Krackhardt 2005 *Victoria University of Wellington Law Review* 319 325–326; Davies and Hopt "Corporate Boards in Europe: Accountability and Convergence" 2013 61(2) *American Journal of Comparative Law* 301 325.

⁶² Krackhardt 2005 *Victoria University of Wellington Law Review* 319 336.

⁶³ Krackhardt 2005 *Victoria University of Wellington Law Review* 319 334.

⁶⁴ *Ibid.*

⁶⁵ *Ibid.*

⁶⁶ *Ibid.*

⁶⁷ *Ibid.*

⁶⁸ Botha "Responsibilities of Companies Towards Employees" 2015 *PELJ* 47 47.

⁶⁹ Esser "Stakeholder Protection: The Position of Employees" 2007 *THRHR* 407 423.

⁷⁰ S 324 DA of the Corporations Act 2001 (Cth).

rotation should form part of the governance structure of auditors in Australia, and then in February 2020 made a recommendation:⁷¹

“Recommendation 6

4.151 The committee recommends that the Financial Reporting Council, by the end of the 2020–21 financial year, oversee the revision and implementation of Australian standards to require audited entities to disclose auditor tenure in annual financial reports. Such disclosure should include both the length of tenure of the entity’s external auditor, and of the lead audit partner.”

The majority of review participants opposed the introduction of mandatory auditor firm rotation in Australia after observing international reactions and empirical research that does not support mandatory rotation of audit firms and which in fact proposes that mandatory auditor firm rotation could be detrimental to audit quality.⁷² Consequently, an alternative solution to mandated auditor rotation was recommended – that additional disclosure of audit-firm tenure should enhance transparency and clarity concerning audit-firm tenure and tendering.⁷³ Clearly, and as supported by the arguments in this article, auditor independence should be accomplished by transparency towards auditor tenure rather than by forced auditor rotation.

4 CONCLUSION

Notwithstanding sound arguments opposing it, mandatory auditor rotation has been implemented mainly based on the argument that it will serve as a publicly acceptable band-aid on damaged investor confidence caused by financial scandals and precipitated by the role of auditors. In the USA, auditor rotation was particularly opposed by the auditing industry, based on cost-implication arguments. It was evident, even in 2006, that many large companies engaged the services of a single audit firm for an average of 22 years and did not have any audit-firm rotation policies. It is clear that auditors are not comfortable with the logic that auditor independence will attenuate where auditor rotation is not implemented owing to favouritism by management, or that the costs of mandatory auditor rotation are justified when regarded in terms of investor confidence lost to incorrect or fraudulent financial statements.

Following the international trend and hassled by government, South Africa introduced the concept of mandatory rotation of corporate auditors into the 2008 Companies Act, notwithstanding a total lack of evidence that auditor rotation would indeed contribute positively to audits. On the contrary, it is not unlikely that the mammoth practical and operational task facing a newly appointed auditor who has to get acquainted with the audit client’s business, may just as easily increase the possibility of their failing to discover material misstatements. Research supports the conclusion that it is illogical to presume audit quality will improve by terminating the relationship between a company and its auditor. Research confirms that audit quality improves over

⁷¹ Parliamentary Joint Committee on Corporations and Financial Services *Interim Report on Regulation of Auditing in Australia* (February 2020) 88.

⁷² Schoeman *The Role and Liability of Auditors* 83.

⁷³ Schoeman *The Role and Liability of Auditors* 84.

the duration of an auditor's tenancy with a specific client and that failure to discover accounting anomalies increases significantly in tandem with an auditor's lack of acquaintance with a specific audit client.

The failure of Steinhoff in 2018, despite the fact that auditor-rotation legislation was in place, underscores the arguments against auditor rotation and accentuates that South Africa followed international trends too hastily. Another far more important concern, which in the long run will have a severe influence on auditor independence, is the fact that mandatory auditor rotation regulations in South Africa have deterred potential candidates from entering the auditing work environment, which is now a less alluring situation.

Still shaken by the recent collapse of other large corporations and banks, the IAASB in typical fashion amended the IESBA Code in April 2020 to enforce rotation of the engagement partner, the engagement quality control reviewer and other key audit partners in the case of financial statement audits of listed entities. Yet again, this was a desperate move to cure a lack of confidence in the auditing profession, despite empirical evidence confirming that the extent of an audit client's earning accruals is inversely correlated to the duration of the auditor-client relationship. The amendment has been implemented, while it is clear that mandatory auditor rotation is detrimental to audit quality.

This article recommends the repeal of auditor rotation in South Africa. It does so especially in view of the relative independence of auditors and on the basis that current provisions are not justified and do not contribute effectively to auditor independence. It further appears that these types of regulations are usually desperate attempts at curbing the public's lack of confidence in the auditing profession, despite empirical evidence that mandatory auditor rotation is indeed detrimental to audit quality. This article therefore suggests that section 92 of the 2008 Companies Act should be repealed to rectify the over-hasty following of international trends around mandatory audit firm rotation regulations, since there is no sign that current provisions contribute effectively to auditor independence.

Lessons learnt from Germany and Australia instead suggest an approach to ensure auditor independence by means of regulations that enhance more transparent disclosure about the company's current auditor tenure and tendering. It is also a more rational approach that recognises existing research that mandatory auditor rotation is indeed detrimental to audit quality. Following the German approach of disclosure of any prior relations with the company or its directors, and revelation of recent or actual contracts with the company or its directors, allows users of financial statements to make their own determination on the independence of appointed auditors. The German approach is favoured because it requires the disclosure of more information than the Australian approach, which only requires disclosure on the length of tenure of the external auditor and of the lead audit partner.