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## **AUD 03: An exploration of audit practitioner opinions on mandatory audit firm rotation in South Africa: a specific focus on market concentration and transformation issues**

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### **Abstract**

*The provision of assurance services, most notably the audit function, is an activity of public protection that requires a high degree of independence between the auditor and the audit client to ensure audit quality is achieved. Internationally, especially in the European Union, there is a legislated move towards mandatory audit firm rotation (MAFR) to ensure auditor independence. South Africa is currently faced with the decision of whether to change legislation and follow suit.*

*The three main reasons why the IRBA are considering further measures, such as MAFR, to strengthen auditor independence are (1) to strengthen auditor independence and so protect the public and investors, (2) address market concentration of audit services and create a more competitive environment; and (3) promote transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets. Internationally, the primary reason that MAFR is considered is to achieve auditor independence and therefore ensure audit quality.*

*Therefore research is needed to assess the credibility of the IRBA's additional reasons, as well as the impact of MAFR on these factors, namely market competition and transformation in the audit profession. Using a qualitative and descriptive methodology, through the use of semi-structured and open interviews with experienced South African audit partners, two of the three key reasons in favour of MAFR, as provided by the IRBA, were explored.*

*The research objective is to document the opinions of a select group of experienced audit practitioners regarding the credibility of the IRBA's additional reasons, as well as the impact of MAFR on these factors, namely market competition and transformation in the audit profession.*

*The results show that the partners interviewed have mixed opinion regarding the ability of MAFR legislation to achieve these two goals appropriately. There is significant concern as to whether MAFR will not actually reduce market concentration amongst the large company audits. MAFR was generally not regarded as South Africa's best option to achieve IRBA's stated goals of increased competition and transformation in the audit profession. There is some difference of opinion between those partners from big four firms compared to those in mid-tier firms.*

## Introduction and Literature Review

### Introduction

The provision of assurance services, most notably the audit function, is an activity of public protection. In the eyes of the public, especially the investing public and all stakeholders of the company, the audit function provides the much needed stamp of credibility and assurance as to the fair presentation of the company's financial reporting. Auditor independence is important because it has an impact on audit quality. DeAngelo (1981) suggests that audit quality is defined as the probability that:

- (a) The auditor will uncover a breach of statutory or regulatory requirement and
- (b) Report the breach to the appropriate parties.

If auditors do not remain independent, they might be less likely to report irregularities or insist that financial statements be prepared to their satisfaction, thus, impairing audit quality (Carey and Simnett, 2006). This potentially lessens the credibility of the financial reporting process and hence why regulations are imposed to ensure the professional standards and the independence of the external audit function. Most countries, including South Africa, have moved away from self-regulation the audit profession, to a system of using an independent regulatory body. In South Africa this regulatory authority is the Independent Regulatory Board for Auditors (IRBA).

Per discussion with the CEO of the IRBA in December 2015, the transcript of which is available upon request, the national regulator is considering advocating a change in South African legislation in order to follow the direction of the European Union in requiring rotation of the audit firm periodically. This system is called mandatory audit firm rotation (MAFR) and its primary purpose is to protect audit quality through promoting the independence of the auditor from the audit client by way of full audit firm rotations every few years. According to the IRBA CEO and consultation paper issued by the IRBA, the main reasons why the IRBA Board must consider further measures to strengthen auditor independence are (1) to strengthen auditor independence and so protect the public and investors, (2) address market concentration of audit services and create a more competitive environment; and (3) promote transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets.

(IRBA, 2015)

### International developments

In recent years, most notably since the collapse of Enron in 2001, regulators have expressed concerns about auditor independence and taken actions to mitigate those concerns (Laurion, Lawrence, & Ryans, 2015). These include the passage of the 2002 Sarbanes–Oxley (SOX) Act, also known as the "Public Company Accounting Reform and Investor Protection Act", which is United States (US) legislation that, among many other requirements, prohibits the auditor (in a US context) from providing most non-audit services to its clients.

In the European Union (EU), regulations have also recently changed. The European Parliament in 2014 voted in favour of Directive 2014/56/EU, amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts (European Commission,

2015). These new rules force European companies to hire new audit firms at 10- to 24-year intervals, depending on certain criteria, bringing mandatory audit firm rotation into one of the world's most significant economic regions (KPMG, 2014).

Other than the more significant recent examples of the UK and the EU, other countries such as Brazil, India, Italy, Spain, Singapore and South Korea have required, and some still do require, audit firm rotation (MAFR) after a maximum specified period (Cameran, Vincenzo, Merlotti, and Cameran, 2005). The US is a notable exception against this international trend and the European Union therefore remains the largest economic jurisdiction to apply MAFR rules.

### The context in South Africa

Currently South Africa does not legislate the mandatory audit firm rotation laws as have been implemented in the EU, but rather follows a system similar to the US, with auditor rotation (i.e. individual audit partner) required every five years. This includes a cooling-off period of two years, as prescribed by section 92 of the Companies Act, 2008 (Act No. 71 of 2008). The profession in South Africa also places a large degree of reliance on the ethical standards in order to internally assess (or self-assess) threats to its independence as auditor. These standards are contained in the International Standards on Auditing (ISAs), as well as the Code of Ethics for Professional Accountants issued by the International Federation of Accountants (the IFAC Code). These are internationally recognised standards for which the auditor can assess their independence from the audit client.

In South Africa there is also regulation and guidance provided to the audit committee of public interest entities to assess the independence of the auditor. This is legislated in the South African Companies Act, 2008 (Act No. 71 of 2008), as well as the King Report on Governance (King III), which is the South African standard on issues of corporate governance. As an example, the Companies Act requires the audit committee to formally assess the independence of the auditor. However, legislation, standards and regulations of the Johannesburg Stock Exchange (JSE) have all stopped short of requiring mandatory audit firm tendering or audit firm rotation as is now being implemented in the EU and the UK.

According to Hay (2015) the research of the effects of rotation of audit firms, including systems of joint audits, is very much in its infancy and requires significant attention, especially considering the recent international focus.

### The position of the Independent Regulatory Board for Auditors (IRBA)

At the forefront of IRBA's mind in the MAFR debate, is the need to pursue a solution that (1) meets the objective of IRBA, but also (2) to be consistent with the priorities set out in the "four key pillars".

IRBA's objective is to endeavour to protect the financial interests of the South African public and international investors in South Africa through the effective and appropriate regulation of audits conducted by registered auditors, in accordance with internationally recognised standards and processes. Therefore the financial interest of the public is utmost priority in the MAFR decision.

However the four key pillars are also important, namely:

1. Comprehensive regulator

2. Independence. Strengthening both the independence of the IRBA and the independence of registered auditors.
3. Leadership in Africa.
4. Transformed profession. Influencing the advancement of transformation in the profession.

(IRBA, 2015)

As part of IRBA's initiative to strengthen auditor independence in South Africa, the regulator has embarked on a series of national workshops and has issued a consultation paper to specifically consider MAFR. Given the importance of responding to the need to strengthen auditor independence, the IRBA Board had a workshop in July 2015 and received comment from audit firms. IRBA also issued a consultation paper in October 2015, requesting comment from executive and non-executive directors. (IRBA, 2015)

According to the consultation paper, the main reasons why the Board must consider further measures to strengthen auditor independence are the following:

- It will strengthen auditor independence and so protect the public and investors, which is part of the IRBA's strategy;
- It will address market concentration of audit services and create a more competitive environment, which will positively influence audit quality; and
- It will promote transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets, provided they are competent to audit in those markets. (IRBA, 2015)

Black economic empowerment (transformation / affirmative action initiatives) is a specific priority in the economy, acknowledged by both business and government as an ethical and urgent national priority. South Africa's history of Apartheid and its impact on the economy and society today has resulted in a widespread desire to "level the playing field" and redress the inequalities of Apartheid by giving previously disadvantaged groups of South African citizens' economic privileges previously not available to them. This has significant impact on the MAFR debate in South Africa.

The purpose of this study is to examine the effects that a system of mandatory audit firm rotation (MAFR), if imposed in South Africa, would have on the South African national priority of transformation as it applies to the audit profession, as well as competition in the audit industry.

## **Literature Review**

The following literature review will examine the impact of audit firm rotation (MAFR) in the few countries that have implemented it through legislation. More studies have been performed on audit tenure in comparison to full audit firm rotation (MAFR), owing to the relatively recent move of jurisdictions such as the European Union and the UK towards MAFR. This review will only focus on mandatory audit firm rotation.

### **The effect of audit firm rotation on audit quality**

A study by Tepalagul and Lin (2015) consisted of a comprehensive review of academic research pertaining to auditor independence and audit quality. Through a review of published articles during the period 1976-2013 in nine leading journals related to auditing, most studies

concluded that long auditor tenure does not impair independence (Tepalagul & Lin, 2015), although there are some mixed results.

As mentioned above, recent studies have mostly concerned themselves with audit partner (auditor) rotation (Bowlin et al., 2014; Daugherty et al., 2012; Laurion et al., 2015; Tepalagul & Lin, 2015), rather than audit firm rotation. According to the South African Independent Regulatory Board for Auditors (IRBA), since the audit failures associated with Enron, larger corporates in South Africa and major financial institutions across the globe, the independence of auditors and regulators have become a focal point for governments and oversight structures (IRBA, 2015). It is for this reason that the recent European Union legislation concentrates on improving independence rotation of audit firms after a fixed period of 20 years; a cap on the amount of fees for non-audit services at 70 per cent of the audit fee; and encouragement for companies to adopt joint audits (Hay, 2015). Investors and the public are also demanding more information and transparency and have become more aware of their rights to be protected (IRBA, 2015). However, there is very little research on the effectiveness and consequences of audit firm rotation specifically. According to Hay (2015) the rotation of audit firms is a difficult area to research because there are so few practical situations where it has been enforced. As a result, “there is no clear evidence about whether it is effective” (Hay, 2015). According to the “The Routledge Companion to Auditing” (2014), as quoted by Hay (2015), “academic research has been unable to provide clear answers about the consequences of mandatory audit firm rotation”.

Two leading studies that have been performed in this area of mandatory audit firm rotation (MAFR), namely 1) Jackson, Moldrich, and Roebuck (2008) and 2) Ruiz-Barbadillo, Gómez-Aguilar, and Carrera (2009) are not in favour of pursuing mandatory audit firm rotation. Jackson et al. (2008) investigated the effect of mandatory audit firm rotation in Australia on audit quality. However, only actual audit quality was examined and while the results suggest that actual audit quality is associated with the length of audit firm tenure, the perception of audit quality by market participants was not addressed. Perception of audit quality is important, as described in the International Federation of Accountants (IFAC) Code of Ethics for auditors (section 290:8), as the need for the auditor to have independence in both mind and in appearance to a third party (International Federation of Accountants (IFAC), 2006). The audit opinion provides assurance to the market and the public of the credibility of the financial statements, as explained in the International Standards on Auditing, ISA 200 (International Federation of Accountants (IFAC), 2009), and therefore this independence of the auditor in the eyes of the market is necessary. According to ISA 200, the audit enhances “the degree of confidence of intended users in the financial statements” (International Federation of Accountants (IFAC), paragraph 3, 2009). Ruiz-Barbadillo et al. (2009) suggested that auditors’ incentives to protect their reputation has a positive impact on the likelihood of them reporting going concern uncertainties. In addition, auditors’ incentives to retain existing clients did not impact on their decisions in both the mandatory rotation (1991-1994) and post-mandatory rotation (1995-2000) periods in Spain.

Therefore the research of Jackson et al. (2008) and Ruiz-Barbadillo et al. (2009), both provide evidence against pursuing mandatory firm rotation. However, no studies have been found that explore the impact mandatory firm rotation on audit market competition nor demographic or employee transformation.

### Competition in the audit industry

Internationally, professional and academic circles acknowledge the fact that there are a dominant set of audit firms, commonly called “the big four”. A large body of academic literature interprets the dominant audit firms in audit markets to be high quality, differentiated suppliers who command higher audit fees (Chu, Simunic, Ye, & Zhang, 2015). According to Gerokos and Syverson (2015), the market’s supply side in the audit industry is highly concentrated. Among publicly traded companies in the United States, for example, the majority of audit engagements and almost all audit fees involve just four audit firms (the “Big four”: Ernst & Young, Deloitte, KPMG, and PricewaterhouseCoopers). In 2010, the Big 4 handled 67% of audit engagements and collected over 94% of audit fees in the US (Gerokos & Syverson, 2015). As discussed by Velte and Stiglbauer (2012), audit markets in many other developed economies exhibit similar concentration, namely an audit market concentration of listed firms which is characterized by an oligopoly of “Big Four” audit firms.

According to Velte and Stiglbauer (2012) this concentration of suppliers on the audit market, is often assessed negatively from the point of view of competition policy, since

- The incentives to ensure cost efficiency and appropriate audit quality are decreasing,
- Higher barriers of entry for small and medium-sized audit firms exist and
- A strong influence from the Big Four on the development of international accounting- and audit standards (IFRS and ISA) must be assumed.

This lack of competition may result in monopolistic pricing, a decline in the quality of audits and of the services provided by audit firms, a decrease in the stability of capital markets and in investor confidence, and the impact on economies of corporate failures.

### Literature review conclusion

There is a move towards mandatory audit firm rotation in many developed economies, with the most significant and recent change in that direction being the European Union in 2014, with the United Kingdom likely to follow suit. The literature reviewed presents mixed results regarding the impact of audit tenure on audit quality and auditor independence, with most studies indicating that independence is not impaired as auditor tenure increases.

Little research has been performed specifically on the link between firm rotation and audit quality, mostly because the move towards firm rotation regulations is very recent and therefore the impact of such regulations is yet to be seen. The studies that have analysed audit firm rotation in countries that have adopted it, such as Australia and Spain, are not in favour of audit firm rotation and do not show clear links to the improvement of auditor independence or audit quality.

The indirect and unintended consequences of a move to mandatory firm rotation has not been studied, nor the perceptions of the various stakeholders involved in the audit process. In addition, no studies appear to have been published in a South African context around mandatory firm rotation. The impact of any proposed system of firm rotation (MAFR) on employment transformation in the audit industry and on competition in the industry, which represent two of IRBA’s three key reasons for pursuing MAFR, must also be researched.

It is generally acknowledged that a lack of market competition is not desirable in any market. However, will MAFR help to decrease this state of dominance by the “big four” audit firms? Will MAFR lower market concentration in the audit industry?



It is generally acknowledged that racial transformation is a specific and urgent ethical and national priority in the South African economy, and therefore the audit industry, like other industries must seek to become more representative of the South African demographic. However, will MAFR help to achieve this goal?

### Problem Statement and Research Objective

The three main reasons why the IRBA are considering further measures, such as MAFR, to strengthen auditor independence are (1) to strengthen auditor independence and so protect the public and investors, (2) address market concentration of audit services and create a more competitive environment; and (3) promote transformation by creating more opportunities for small and mid-tier audit firms to enter certain markets. Internationally, the primary reason, if not the only reason, that MAFR is considered is to achieve auditor independence and therefore ensure audit quality. Therefore there is a degree of scepticism in reaction to IRBA's announcement to pursue MAFR as a means to also transform the audit industry and increase competition.

Therefore the research objective is to document the opinions of a select group of experienced audit practitioners regarding the credibility of these additional objectives, as well as the impact MAFR will have on these objectives, namely market competition and transformation in the audit profession.

### Research Methodology

This is a descriptive study that employs a qualitative research methodology. Qualitative studies aim to explain the ways in which people come to understand and account for issues, event and behaviours in their lives. Therefore the data gathered covers the perceptions, opinions and reasoning of the participants based on their unique experiences of areas related to the topic studied.

The purpose of this study is to explore the perceptions and opinions of the South African audit practitioners regarding the proposed move towards mandatory audit firm rotation (MAFR), and whether it will achieve the goals intended by the IRBA. To achieve this semi-structured interviews were performed with experienced partners across a number of audit firms nationally. A semi-structured interview is a qualitative method of inquiry that combines a pre-determined set of open-ended questions (questions that prompt discussion), with the opportunity for the researcher to explore particular themes or responses further. This type of interview does not limit respondents to a set of pre-determined answers, unlike a structured questionnaire for example (Dearnley, 2005).

The purpose of the semi-structured interviews is to understand the breadth of issues and opinions around adopting MAFR in South Africa, as well as opinions regarding possible alternatives to, and unintended consequences of, MAFR. Therefore this study aims to document the breadth of the issues and opinions using a small sample of audit partners so as to allow the second natural step in the research, which is produce and implement a comprehensive and appropriate field survey of the audit profession. This survey is to be sent more broadly to the profession where the intention will be to receive responses from a much larger sample of audit practitioners, i.e. audit partners around the country. Note that the second step is not the purpose of this paper, but rather an important area for further research based on this study.

Semi-structured in-depth interviews are the most widely used interviewing format for qualitative research and can occur either with an individual or in groups (DiCicco-Bloom and Crabtree, 2006). The open nature of the questions encourages depth and vitality in the responses by the interviewees and allows new concepts to emerge over the course of the interviews (Dearnley, 2005).

### The population and the selection

This study employs a purposive sampling technique, also known as judgemental, selective or subjective sampling. Purposive sampling is a type of non-probability sampling which focuses on sampling techniques where the units that are investigated are based on the judgement of the researcher, rather than on statistical techniques (Lærd Dissertation, 2016). Purposive sampling technique is most effective when one needs to study a certain domain which contains knowledgeable experts. In choosing a sampling method for informant selection, the question the researcher is interested in answering is of utmost importance and it is especially important to be clear on informant qualifications when using purposive sampling (Tongco, 2007).

Fourteen experienced practicing “registered auditors” (audit partners) were selected from nine different audit firms in order to perform the interview (refer to table below). According to the book entitled “The Long Interview” by McCracken (1988), as cited in DiCicco-Bloom and Crabtree (2006), in-depth interviews are used to discover shared understandings of a particular group and the sample of interviewees should be fairly homogenous and share critical similarities related to the research question. This selection of audit partners is therefore the homogenous group that share critical experience related to the research question. The selection is also considered to be fairly representative of the population of registered auditors in South Africa, especially considering that the audit partners selected were involved in the senior leadership of their respective audit practices and were considered sufficiently experienced as audit practitioners, having worked for many years in the capacity of audit partner.

The commonly agreed and recognised distinction between the audit firms (Marx, 2009; Rapoport, 2016) has been used in this study and is as follows:

- “Big four” audit firms refer to the largest four accounting and audit firms globally, namely Deloitte, PricewaterhouseCoopers (PwC), Ernst & Young (EY) and KPMG. These four firms are also referred to as “large-tier” firms (ICAEW, 2016).
- The non-big four firms are either mid-tier or small-tier firms depending on their respective global size, global presence and capabilities as an audit firm in terms of resources (ICAEW, 2016; Rapoport, 2016).

The researcher and the participants in this study will use these terms in the interview discussions. The following is a description of the fourteen practitioners interviewed:

- All the partners were considered senior and highly experienced, ranging between seven years as a practicing audit partner and thirty-three years. The average number of years as a practicing registered auditor of all interviewees is 22 years.
- Seven of the partners were either a regional or a national managing partner in the firm and therefore in key leadership and strategic roles within their respective firms. The



remainder were senior partners who also held significant leadership responsibilities and portfolios within their respective firms or network of firms.

- The audit firms were selected from Johannesburg and Cape Town offices of the network firms.
- Of the fourteen partners, two were women.
- The two largest black audit firms in South Africa, namely SizweNtsalubaGobodo Inc. and Nkonki Inc. were represented. These two firms are the largest “black-owned” audit firms in South Africa and have grown to considerable size to rival the traditional “mid-tier” firms.
- Five partners were from the “big four” international audit firms.
- The remaining partners were from the “mid-tier” audit firms (including the “black-owned” medium size firms) who also perform audit services of public interest entities.

The below table shows a further description of the audit partners (participants) interviewed, including the number assigned for the purposes of analysing the results of the interviews, i.e. “Audit Partner 1”; “Audit Partner 2” etc.:

<b>Designation of Participant in Analysis of Results</b>	<b>"Big four" or "Mid-tier" or "Black-owned Mid-tier" firm</b>	<b>Position</b>	<b>Years as Practicing Audit Partner</b>
<i>Audit Partner 1</i>	Big four	Senior partner	25
<i>Audit Partner 2</i>	Big four	Managing Partner	20
<i>Audit Partner 3</i>	Big four	Senior partner	25
<i>Audit Partner 4</i>	Big four	Senior partner	9
<i>Audit Partner 5</i>	Big four	Senior partner	23
<i>Audit Partner 6</i>	Black-owned Mid-tier	Managing Partner	22
<i>Audit Partner 7</i>	Black-owned Mid-tier	Managing Partner	23
<i>Audit Partner 8</i>	Black-owned Mid-tier	Senior partner	29
<i>Audit Partner 9</i>	Mid-tier	Managing Partner	32
<i>Audit Partner 10</i>	Mid-tier	Managing Partner	17
<i>Audit Partner 11</i>	Mid-tier	Senior partner	16
<i>Audit Partner 12</i>	Mid-tier	Managing Partner	33
<i>Audit Partner 13</i>	Mid-tier	Managing Partner	28
<i>Audit Partner 14</i>	Mid-tier	Senior partner	7

### Interview process and methodology

Each interview was held in person with the respective participants and lasted between one and two hours, the discussion audio being electronically recorded with the express permission of each participant.

According to Leedy and Ormrod (2010), qualitative data analysis ideally occurs concurrently with data collection so that the researcher can generate an emerging understanding about research questions, which in turn informs both the sampling and the questions being asked. This was certainly the case within this study as the interviews process was being conducted, as new opinions documented fed into and shaped the subsequent discussions with interviewees. This iterative process of data collection and analysis eventually leads to a point in the data collection where no new categories or themes emerge, referred to as saturation, signalling that data collection is complete (DiCicco-Bloom and Crabtree, 2006). Saturation is believed to have been reached in these interviews in the sense that no new themes or categories surrounding the question of MAFR emerged in the last interviews, indicating that the sample of fourteen practitioners was sufficient for the purpose of the study. The transcribed data was then used in order to identify common, recurrent, or emergent themes around the issue of the role of audit committees is preserving auditor independence and quality financial reporting, rather than pursuing MAFR in South Africa.

## Presentation and Analysis of Results

### Competing objectives

It was clear that the mid-tier audit partners, especially the representatives of black-owned emerging audit firms, were mostly of the opinion that MAFR, or maybe an alternative such as combined audits, would improve competition (market concentration) and transformation in the audit industry. In response to this argument other partners, mostly comprising of the big four audit partners, pointed out that the IRBA needs to be clear as to what exactly any change in regulation is trying to achieve. Is the IRBA attempting to improve audit quality or are there other priorities driving the agenda, such as market concentration and transformation objectives? More than one partner was sceptical that the IRBA claims that MAFR or any alternative to MAFR is primarily being considered to improve audit quality in the interest of public protection. IRBA has explicitly stated that there are three reasons for pursuing MAFR, however, the primary reason is to enhance audit quality (IRBA, 2016).

The participants who expressed this sceptical view around the IRBA's priorities, believed that there were better ways to achieve the other objectives, namely healthy market competition and economic transformation, rather than imposing such significant additional regulation on the industry. In their view any discussion on MAFR (or an alternative) should only be considered if it did indeed improve audit quality as the only objective. These partners were adamant that by pursuing other objectives (in addition to audit quality) in the decision around MAFR could actually result in a loss of audit quality.

### Addressing market concentration

All the audit partners expressed concern, despite their other differing opinions on other related matters, that a significant unintended consequence of forcing MAFR on South Africa would be

the likelihood that the audit of large companies (particularly the listed companies) would simply rotate around the big four audit firms and therefore actually reduce competition rather than grow it.

There was significant disagreement as to whether market concentration was a concern. As could perhaps be expected, none of the big four partners believed that market concentration was a problem or that it was the regulator's (IRBA) place to step in to actively address it. Of the partners who agreed that market concentration was a problem, all were in favour of a system of joint (combined) audits rather than MAFR as a means to improve competition. It is fair to say, and a significant observation, that there was no person interviewed who was in favour of a direct move from the current system to one of MAFR, either to improve independence or to improve competition in the audit industry.

In response to being asked whether MAFR will allow mid-tier to compete for the larger company (public interest entity) audits, one big four partner's response was as follows:

**“I think all you're going to do is have 'the shifting of the deck chairs'. The big four will remain the big four. There might be the transformation angle so maybe the big five. You know I'm saying, given the South African avenue here and you might, let's be fair, call it the big five, that it's going to be a 'shifting of the deck chairs'. That's all that's going to happen. Is the Audit Committee, given the strength of the Audit Committee, are they honestly going to appoint a firm that clearly hasn't had the experience, doesn't have the resources, the staff, to do a large listed company audit? No disrespect to the second tier firms or let's call it the next tier. I mean, clients expecting us to have the depth and breadth of skill and how these smaller firms going to acquire that skills and also have the ability to deliver seamless service across numerous jurisdictions. Our clients expect us to be in every location where they're located and they want us to speak with one voice. How are these other firms going to do that? If you look at what has gone out to tender, the, from what I understand in the UK and the likes, it's really just shifting it around and there's no major... So when they, and those that have gone out to tender, where has it gone? You'll most probably find that the smaller firms, one of them will get invited to come and tender, but they'll fall out somewhere along the process. [It is not going to address market concentration], it's just going to shift between the big five, put it that way. That's honestly the way I see it.”** (*Audit Partner 5*)

Referring to the larger listed multi-national companies, one partner made the point that in their opinion, having been involved in a few companies of this size and geographic diversity, the mid-tier firms could not possibly perform assurance services on that scale. In that sense MAFR would actually reduce competition as these audits would have to move from the one big four firm to one of the other three.

**“Because there's only going to be three left. There's no way that a mid-tier firm will do the [company name] audit in 130 countries within the next twenty years.”** (*Audit Partner 2*)

This opinion is also shared by some mid-tier audit partners. The concern is simply that the audit committee, when faced with having to choose another audit firm during a mandatory rotation is likely to stay with a big four firm, rather than risk negative stakeholder perception by moving away from the big four.

**“But what I want to come to, is typically when we get an opportunity to make a proposal for a big public company that’s audited by the big four, and you go there and you really... I mean, in this one instance we really went to town with the presentation. And in the meeting you can pick up that people are quite positive, and then you get the letter saying no, they’re staying with the current big four auditor. So on reflection, think about it, you’re an independent, non-executive director on an Audit Committee where you’re at risk. So are you really going to change the incumbent... to ‘Joe Soap’? To a non-big four? Or just change from the big four? Let’s say they do it. Let’s say they’ve got that type of appetite for risk, or perceived risk. And they do it, and it’s a stuff-up. [Then their heads are on the block.] If they had moved from big four firm to big four firm then... nobody could fault that. You would went from the same to another... you’re just going to go in a circle. That’s not going to improve market concentration at all. You may even see a movement up to the bigger firms.”** (*Audit Partner 14*)

In the experience of a big four audit partner:

**“I’ll give you an example... I have just gone through a proposal process. It’s not a large firm. It’s actually mid-market firm. I went to see the chair of the Audit Committee afterwards and he gave me the feedback and one of the things he specifically said was, it was clear to them, the Audit Committee and the panel. It was not just the Audit Committee - management was a part of the panel. That there was a big difference in the quality of the whole process and the documents and the presentations. Between the big four and the next tier. That was clear [to them]. He then immediately said “forget about anything below the big four”.”** (*Audit Partner 3*)

Considering the risk involved and the experience, skills and size of mid-tier firms, why would the audit committees of large companies award the audit to a non-big four firm? Is this a realistic expectation? This was a common question raised by audit partners, of both large and mid-tier firms and it is a serious concern for the ability of MAFR to improve participation of the mid-tier firms in large public interest entity audits, especially JSE listed companies. Audit committees of larger companies would be less inclined in their opinion, for reasons of perceived risk or quality or resources, to award tenders to non-big four firms, regardless of whether MAFR was introduced.

One partner expressed, regarding large listed companies in particular, that the current system of five year partner rotation, together with the audit committee and shareholders having the power to put the audit out for tender, allows all four big four audit firms (or all firms for that matter) to bid for appointment – including the incumbent big four firm. However, the effect of MAFR would change this significantly. Under MAFR regulations the audit committee and shareholders will be required to rotate the incumbent big four firm, but the incumbent will not be allowed to bid for the tender i.e. to bid for reappointment. Therefore, since the audit committee will likely only favour another big four firm (as it is a listed company), this results in only three possible choices for auditor - as opposed to four in the current system. So the thinking is that MAFR in effect will actually reduce competition in practice. Can the audit committee of a large listed company realistically be expected to award the tender to a non-big four audit firm, considering stakeholder perceptions and the size and experience of the mid-tier firms? The majority of the audit partners interviewed agreed with this reasoning as far as it applied to large listed entities. This effect will therefore be to reduce market competition in the audit industry.

Another argument that MAFR would actually reduce competition was expressed by mid-tier audit partners, with the point that the smaller firms do not currently have the skills, experience or resources to service the large complex companies. Many of the big four partners made this point as well. And how could the leadership of the audit firm gear up to responsibly perform such audits if firstly they may not be awarded the tender and secondly they will only have the client for the rotation period, whatever period that may be legislated under MAFR?

**“We don’t have the skillset for the banks and then the insurance companies as well - unless they are really small, so you can pick on a mega insurance company. You know we don’t have the manpower and then to gear up the manpower for five years you know... [from a business perspective] you can’t, commercially...”** (*Audit Partner 12*)

This partner went on to express that because of the problem that the incoming audit firms will need to urgently procure the skills and experience to perform the audit professionally, the firm will be tempted to offer the staff from the outgoing audit firm jobs on their audit team. This was referred to by the partner as “cheating the system” of MAFR.

**“What can happen is you know the guys will cheat like they are cheating on the section 90 [of the Companies Act], they will loan their teams around or a team will come and they will be here for five years and the guy will bring his team along and you will find the same people will do [the audit]... a kind of secondment.”** (*Audit Partner 12*)

An example of this was then given with the internal audit function of a large South African state-owned entity that outsourced this function to one of the big four audit firms. What then happened according to this audit partner was that the audit firm then employed most of the state-owned entity’s internal audit staff, with the effect that they left the company to work for the audit firm but to perform the same services as the internal audit function. In the words of the partner, **“it’s the same team but they had different houses, so the guys have to have the economic necessity to do that. So I really don’t have a warm feeling or a strong recommendation for mandatory audit rotation and I really don’t think that audit independence is such a huge issue in South Africa.”** (*Audit Partner 12*)

The same opinion was expressed by Audit Partner 4:

**“I think it was, it could be Brazil... What happened when they realised that a big team, let’s say a [company name] team will do the audit and then a year before the whole firm has moved to let’s say to [firm name] or another firm, the other firm starts headhunting them and then effectively, that whole team is moving and his partner is moving across to the new firm. Now how’s that for independence? It is just under a different umbrella somewhere and another firm must sign it, but it’s the same team. So to overcome this cost and knowledge and all those things, this team just moves over.”** (*Audit Partner 4*)

Will MAFR rotation result in this kind of “headhunting” and employment relocation? If so, the will it occur to such a degree as to negate the added independence that MAFR is intended to produce. The partners who expressed this concern made the point that it would be an economic necessity and make good strategic sense to source the staff who were involved in the audit before the rotation. In their opinion this has already been happening, albeit in a very limited capacity, under the current partner rotation scheme. MAFR would perhaps incentivise the firms to do it on a larger scale.

### Transformation considerations

All the partners interviewed who were not members of the black emerging audit firms (11/14) expressed serious concern regarding whether the black-owned firms who have been awarded large public tenders have the resources, skills and experience to audit such large public interest entities. The concern was that if a firm is under resourced for the job, or has no prior experience with a specific industry, then a drop in the quality of the audit process and audit outcome is inevitable. Government, in their opinion, has been far too quick to award such large tenders to the black-owned audit firms and should have either sought joint audit arrangements for longer or promoted the ability of existing audit firms to transform from within as a better method of achieving transformation objectives. This concern expressed is very similar to that which all the mid- and large-tier firm partners expressed regarding the upskilling required of non-big four firms before they are sufficiently capable to service the large listed companies. Therefore the opinion expressed was that MAFR poses a significant risk to audit quality if a smaller audit firm, whether black-owned or not, is placed in a position too soon to audit a large company or group of companies. Here we see the possibility of MAFR to either result in reduced audit quality if this situation occurs. Or it could result in the audit committees not awarding the audit to smaller (non-big four) firms and MAFR causing reduced competition as the large company audits rotate around the big four firms only. All these possible consequences would be contrary to the IRBA's intentions of reduced concentration and increased transformation.

So what were the opinions of the black-owned firm audit partners about their ability to service larger and more complex companies? When asked whether non-big four audit firms, including the black-owned firms, had the skills and resources to handle the larger and more complex company audits, the managing director of a black-owned firm (Audit Partner 7) responded that there is a problem with perception rather than with reality. In their opinion the mid-tier firms can audit the larger entities and it is wrong to simply assume that they don't have the skills or resources because they are not big four firms. This partner expressed how difficult it was for them to just be appointed as a service provider to large companies for non-assurance work, because there is such a strong perception that their firm lacks the skills and resources. However, they believed that the perceptions are slowly changing as they prove themselves in the non-assurance work and in joint audit arrangements. This opinion by a black-owned audit firm partner is in contrast to the big four partner and some mid-tier partner opinions, which hold that the smaller firms cannot yet audit the bigger listed entities, many of which are multi-national companies.

Again the concerns expressed in this regard contrasted the differing objectives of improving audit quality so as to achieve sufficient public protection on the one hand, and achieving black economic empowerment (transformation) in the profession. If regulation changes are pursued with too many objectives in mind, or with too little research and stakeholder consultation, then the unintended consequence of a loss of audit quality may result. As many partners pointed out, surely public protection through enhanced audit quality should be the only reason for changing reason in favour of MAFR? And if so, most, if not all partners interviewed, believed that MAFR was not going to achieve improved audit quality.

Of particular interest was the fact that all the non-big four partners were of the opinion that market concentration of the public interest company audits was a problem in South Africa and



needed to be addressed for the good of the profession and the public. Many admitted that this was not a South African specific problem by any means, however South Africa was in a unique position whereby transformation was also a high priority in business, across all industries in the economy. By addressing market concentration appropriately in the profession through whatever means was considered most appropriate, it would also thereby improve transformation, as it would allow the smaller black-owned emerging firms to compete in the private sector, together with the other non-big four firms. The big question that was raised numerous times was the question of whether MAFR was the best means to achieve this transformation. None of the partners, including those from black-owned firms believed it was the best means. As mentioned already, there was one black-owned partner (Audit Partner 7), who was tentatively in favour of MAFR, but only if significant corporate governance weaknesses were addressed first and it was pursued carefully and in a slow staged process, such as via a period of requiring joint audits, to allow the non-big four firms time to gain experience with the larger more complex companies.

A common concern from the mid-tier firms, referred to by one partner as a “chicken before the egg story”, was the constraint around gearing up your audit firm to service large companies. This improved capacity in the mid-tier is one of the IRBA’s clear intentions for MAFR i.e. improve competition in the audit sector, including the ability of black-owned firms to compete, which promotes transformation as well. However, how do mid-tier and black-owned firms upskill and increase their resources so as to responsibly and professionally provide audit services to large private companies? How do they afford to do so without first being appointed as auditors? How, from a pure business perspective, can they justify the cost and the risk of increasing staff and other resources on the hope that their firm will be appointed as the auditor? This was seen as a significant restraint to MAFR achieving improved competition and transformation. One partner from a mid-tier firm (Audit Partner 10) expressed the concern that simply increasing staff numbers in expectation of MAFR and in expectation of receiving more appointments (referring to mid-tier and black-owned firms), is dangerous as you need the right skills and the right experience, not simply the numbers and the technology. Or else the sacrifice will be reduced audit quality. A number of partners expressed that this is perhaps what has already occurred by the appointment of the emerging black-owned audit firms to the large public sector and state-owned enterprise audits. Do they (or did they when first appointed) have sufficient skill, experience and resources for such large, high audit risk, high public risk entities?

Some partners suggested that either promoting transformation within the existing firms or allowing mergers with the black-owned firms was preferable to MAFR in promoting transformation. One partner who was not from one of the emerging black-owned audit firms acknowledged that although many consider mergers of these audit firms with the “more established firms” as a solution to promoting transformation in the audit profession, it may not be wise.

**“We can’t just take a black firm and a traditional western firm and merge them because of transformation and think it would be the right thing to do. There are still certain things that those of us from a privileged background maybe just don’t understand about the way people work and the issues that they’ve had to deal with that we are not used to.”**  
*(Audit Partner 10)*

This person went on to state that therefore joint audits may be a better solution than pursuing MAFR or a simple mergers of firms. Joint audits better allow for a mentoring process and skills transfer to emerging black firms, while preserving their autonomy and growth as a separate firm in the market.

Perhaps in disagreement over the regulator's (IRBA) thinking around transformation through growth of the emerging black-owned firms, the big four audit partners were quick to point out that their firms, and others, were transforming and this should be recognised by the regulator. One managing partner (Audit Partner 2) of a big four firm stated that their target at the moment in the near future is to reach 70% black staff and they were currently on an actual number of around 50%. This partner went on to state that other big four firms may be doing even better and that would mean that the largest "black firms" in terms of number of staff were actually the big four firms, not the so-called "black-owned firms". The main point being made was that the IRBA needed to recognise these transformation achievements at the firms and therefore no focus on changing legislation to achieve transformation, especially not through MAFR.

Two of the partners interviewed were managing partners of leading South African black-owned firms and so their opinion on MAFR is particularly significant in light of the IRBA's transformation objectives. The one managing partner of a black-owned firm (Audit Partner 7) was of the opinion that MAFR rotation was good for South Africa, and was the only partner of the fourteen interviewed in favour of MAFR, albeit tentatively in favour. They were in favour provided that significant corporate governance weaknesses were addressed first, most importantly being the dominance of management in the appointment and managing of the external auditor, and if MAFR was pursued carefully and in a slow staged process, such as via a period of requiring joint audits, to allow the non-big four firms time to gain experience with the larger more complex companies. In their opinion, if these issues are not addressed, then MAFR will not improve transformation nor auditor independence and audit quality. The other qualification this partner made was that the period of the rotation must be carefully determined so as not to encourage unfamiliarity and lack of institutional knowledge of the client (if too short) or promote familiarity threats (if too long).

The other black-owned firm managing partner (Audit Partner 6) was of the opinion that MAFR was not the right answer for South Africa, mostly because it would result in a loss of institutional knowledge built by the firm. This partner was of the opinion that five year partner rotation was sufficient as it allowed the firm to retain the institutional knowledge and experience and professionally manage any independence threats through its own firm and professional codes and practices.

**"But my personal view is I don't believe in mandatory audit environments and I'll tell you why. To a very large extent, especially in large complex operations, it takes time for one to really fully get to grips with the environment. And I see you've got other subsequent questions around we should rotate the senior, the entire senior leadership or just the, the lead partner as such. And frankly, for one to have proper institutional knowledge of that, which is institutionalised, you would need them to be there... I'm saying I'm not supporting mandatory firm rotation. One, because frankly I don't think it has a bearing on independence. Like I say, I think we've got enough safeguards in the current systems to manage and govern independence."** (Audit Partner 6)

In addition to these concerns expressed above, this partner was also concerned with the likelihood that MAFR will simply become a “game of musical chairs” amongst the big four firms, thereby reducing market competition, as well as promoting low-balling of fees to secure the appointments.

These opinions from the two managing partners of South Africa’s largest black-owned audit firms is significant to the MAFR debate, certainly as far as transformation and market concentration aspects are concerned.

## Summary and Conclusion

There was considerable mixed opinion regarding the effect that MAFR legislation may have on the priorities of increasing market concentration and economic empowerment (transformation) in the audit industry. Significantly, all partners interviewed were in agreement that MAFR is not the best option for South Africa if audit and financial reporting quality is the only objective. Many partners criticised IRBA’s competing objectives of audit quality, improving competition and transformation as they believed that MAFR must be pursued for audit quality reasons or not at all. In their opinions, pursuing competing objectives will likely result in actually reducing audit quality.

Most audit partners believe that MAFR will, counter to the IRBA’s intention, reduce auditor competition for the large public interest entities, rather than improve it. This is mostly because the outgoing big four firm will not be allowed to tender for the appointment and most audit committees will only consider the “big three” firms who tender. There is some disagreement among mid-tier firms as to whether they have the resources and experience to audit the larger companies on the JSE. Some believe they simply do not, other believe that they will easily upskill and it will not result in a sacrifice of audit quality.

None of the big four audit partners believe that MAFR will improve transformation, but rather believe that transformation is best addressed in the existing firms with the existing set of regulations. The managing partners of the two largest black-owned audit firms in South Africa did not believe that MAFR legislation was the best route for South Africa, with one quite firmly against it, and the other tentatively for MAFR if done slowly and only after deficiencies in the functioning of audit committees was addressed first.

These findings show clearly that key leaders of audit firms are against MAFR as a means of addressing any objectives other than audit quality itself. There are better means to address concerns around competition and economic transformation in the audit industry. The unintended consequences of MAFR have the potential to actually cause a reduction in audit quality. It is recommended that the IRBA clearly articulate how, in their view, MAFR is intended to address market concentration and transformation; and respond to the many concerns that the audit practitioners have in this regard. More dialogue with key stakeholders, especially the audit practitioners themselves, as well as research around unintended consequences, is required before a final decision can be made by the regulator.

### Areas for further research

MAFR has not been extensively researched internationally and certainly not in a South African context. This research is not intended to be representative of the population of audit practitioners in South Africa. A national survey of the South African audit profession is necessary in order to provide a representative view from the profession on the issues

surrounding MAFR, especially the likelihood and nature of unintended consequences. The impact on, and the opinions of, other stakeholders such as audit committee members, management and investment professionals needs to be understood as well. The impact of MAFR in other key international jurisdictions such as the European Union also needs to be explored.

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