

Recent Developments in Auditor Tenure and Independence

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by Nicole H. Strydom

Last month, over 35% of General Electric Co.'s shareholders voted against ratification of KPMG LLC as GE's auditor. This high level of opposition (for some context, last year's votes against KPMG were at a mere 5.7%) comes in the wake of GE's recent accounting issues and criticism from proxy-advisory firms. More specifically, the SEC is currently investigating some of GE's accounting practices, including its need for increased reserves in its insurance operations and its revenue recognition accounting for long-term service agreements. KPMG, which has been GE's auditor for 109 years, didn't catch any of these issues.

While GE's 109-year relationship with KPMG may seem unusual, in the context of large U.S. companies, a relationship spanning 50 years or more is relatively common and, as many will argue, beneficial. Long tenures mean that the auditors have deep institutional knowledge of the company and are potentially more cost-effective, since auditor changes consume significant resources as the new auditor is getting up to speed.

Auditor tenure has been the subject of rulemaking by regulatory bodies here and abroad:

- In June 2017, the Public Company Accounting Oversight Board (PCAOB) finalized a new standard requiring that auditor's reports disclose the length of the relationship between the company and its auditor. This new standard, which is applicable to audits conducted after December 15, 2017, was adopted amidst concerns that lengthy auditor tenures could mean greater tolerance of "creative" accounting and susceptibility to turning a blind eye to management issues. Proponents of the new standard claimed that disclosing tenure length was an important data point for investor consideration.
- Back in 2011, the PCAOB issued a concept release that broached the topic of mandatory audit firm rotation due to independence concerns, but after significant pushback from both auditors and companies, the topic was tabled.
- In the European Union, a mandatory audit firm rotation requirement has been in place since 2014: public companies must rotate auditing firms every 10 years, with the potential for an additional 10 years provided a competitive bidding process is conducted.

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Last Wednesday, the Securities and Exchange Commission issued a proposing release to “refocus the analysis [of] whether an auditor is independent when the auditor has a lending relationship with certain shareholders of an audit client.” The release shows that the SEC is once again thinking about auditor independence, and its call for comments on whether the SEC should “make other changes to our auditor independence rules” could lead to some interesting discussion in the coming months.