November 18, 2003

To: Audit Committee

From: Auditor General

Subject: External Auditors – Policy of Rotation

Purpose:

To report on a policy of rotating the City's external auditors on a pre-determined cycle, as requested by the Audit Committee.

Financial Implications and Impact Statement:

There are no financial implications resulting from the adoption of this report.

Recommendations:

It is recommended that all future Request for Proposals for external audit services include a provision that the lead audit engagement partner must be rotated in circumstances where the incumbent audit firm is the winning proponent.

Background:

The Auditor General is required, among other responsibilities “To oversee the work of external auditor(s) performing financial statement/attest audits.” As the contract with the firm of Ernst & Young LLP expired with their completion of the audit for the year ended December 31, 2002, it was necessary to select and appoint auditors for subsequent years. The Auditor General completed this responsibility by issuing a Request For Proposal (RFP) for external audit services for the years 2003 to 2007 for the City itself and its more significant Agencies, Boards and Commissions. The external attest audit of Arenas, Community Centres and other miscellaneous entities and Business Improvement Areas has been determined through a separate Request for Proposal.

The RFP for the City itself and its major Agencies, Boards and Commissions was circulated to the 16 largest firms with a presence in the Toronto area and proposals were received from the following three firms: Deloitte & Touche LLP; Ernst & Young LLP; and KPMG LLP.
In a report dated May 29, 2003, the Auditor General recommended the firm of Ernst & Young LLP, the proponent with the highest overall evaluated score and the lowest cost, be retained for the provision of external audit services for the City and its Agencies, Boards and Commissions, for the years 2003 to 2007 inclusive at a total cost of $3,764,000 including expenses and applicable taxes. Ernst & Young were the incumbent auditors. This recommendation was approved by City Council at its meeting of September 22, 2003.

Comments:

Public concerns related to the recent U.S. corporate financial scandals, such as Enron and Worldcom, led to the passing of the U.S. Sarbanes-Oxley Act in 2002. The Act includes a variety of measures to improve corporate governance, including new reporting requirements to restore trust in the information corporations provide to the public. Although no such legislation exists in Canada, there is impetus to strengthen corporate governance and to increase the perception of independence and objectivity on the part of public accounting firms who are engaged to attest to the financial results of corporations.

The Audit Committee has raised the issue of adopting a policy of mandatory rotation of the City’s external auditors on a pre-determined basis. In general terms, it could be perceived that a lengthy audit engagement allows the incumbent to become too familiar with the client, whereas, mandatory rotation may facilitate a fresh look at the City’s financial results and operations. In addition, there may be a perception that there is less risk to potential impairment of independence and objectivity if such a rotation policy is followed.

It is important to appreciate that all public accounting firms have strict professional policies on independence and they abide by the Code of Ethics established by the Canadian Institute of Chartered Accountants (CICA). Independence and objectivity of auditors is critical to public and investor confidence and the CICA has introduced a draft of a pronouncement which promotes a new, stronger independence standard that will be adopted within the Code of Ethics.

Within the private sector, banking and investment firms, for example, have had a history of engaging a primary audit firm plus two secondary firms with some form of mandatory rotation required every two years. With the introduction of the new bank act, these organizations have moved away from this practice, as there is a preference to have a single audit firm responsible for the audit. Some of the reasons cited are that the audit is conducted more efficiently, there is a single contact or partner in charge and there is more control over the use of consultants.

Three of the “Big Four” public accounting firms responded to the recent RFP for external audit services although it is possible that a number of the “second-tier” firms could manage a large municipal audit like the City. A policy of mandatory rotation over a period of time might be perceived as limiting the competitiveness for the City’s audit. In addition, reduced competitiveness could increase the cost of the audit.
One of the negative impacts that a policy of rotation may have is the potential loss of continuity and financial history of the operation that an audit firm accumulates over time. The increased knowledge of City operations gained through a longer association usually has a direct impact by increasing the efficiency of performing the audit. A mandatory rotation every five years results in an extensive learning curve during the first year of the new firm. While this may not impact the cost of the audit, there is an indirect cost as there is a heavy reliance on the City’s Finance staff to train and educate the new firm.

The CICA’s new draft independence standard, among other measures, requires that the lead engagement partner on a public company audit client must be replaced after five years and cannot resume such a role for a further two-year period. Most large public accounting firms have adopted policies requiring the mandatory rotation of audit partners for large public clients. A rotation of audit partners provides new insight and a fresh look at the audit engagement without losing the history or continuity of knowledge concerning the audit entity’s operation and has no impact on audit cost.

Conclusions:

A policy of rotating the external auditor on a pre-determined basis may have the perception of increasing the independence and objectivity derived through the audit process. Perception is not always reality, as all public accounting firms have strict professional policies regarding independence and are guided by a professional Code of Ethics, including an independence standard and strict peer review procedures. In addition, such a policy may increase the cost of the audit through a reduced competitive environment and through increased demands on City Finance staff during the initial year of each audit firms’ rotational period.

There are other options available to ensure that objectivity and independence is obtained from the external audit process. It is suggested future RFPs for external audit services require that an incumbent audit firm adopt a mandatory policy for the rotation of the lead audit engagement partner every five years. These measures will increase the efficiency and effectiveness of the audit process without prohibitively impacting the cost of the audit.

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