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POSSIBLE IMPACT OF ROTATION TO AUDITORS INDEPENDENCE AND MARKET CONCENTRATION /CASE OF ARMENIA/

This article presents the current international trends, problems and prospects in development of audit, issues related to independence, audit company rotation, and market concentration. The recent crisis in the global economy has revealed some new problems of audit that contributed to the further deepening of crisis and did not predict its occurrence in advance. The aim of this article is discussion of the problems connected with audit market concentration and elaboration of ways for solutions. Together with problems in this article also discussed recently published international guidelines in the field of audit for strengthening the profession.

Key words: audit, auditor Independence, quality, concentration

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ВОЗДЕЙСТВИЯ РОТАЦИИ НА НЕЗАВИСИМОСТЬ АУДИТОРА И КОНЦЕНТРАЦИИ РЫНКА /ПРИМЕР АРМЕНИИ/

В статье представлены современные международные тенденции, проблемы и перспективы развития аудита, которые касаются независимости и ротации аудиторской компании. Недавний кризис в мировой экономике выявил новые проблемы аудита, которые надеемся лишь частично способствовали углублению кризиса, но точно можем сказать не предупредили о возможном появление

заранее. Цель статьи выявление проблем по обеспечению качества аудита, воздействия ротации аудиторской компании на независимость и разработка современных подходов решения. В этой статье также обсуждены опубликованные международные руководства в области аудита направленные на укрепление профессии.

Ключевые слова: аудит, независимость аудитора, качество, надзор, ротация.

Formulation of the problem. Nowadays professionals do not object that audit has increased value to financial statements users. It is performed by a competent and independent third party who has no interest in the financial success of the company. Investors can be sure that independent professionals have performed required procedures and have a reasonable basis for the opinion that the financial statements present fairly. Independent audit contributes to investor protection by providing trustworthy information about the financial statements of companies and can reduce various forms of risk in an enterprise, including the risk of material misstatement in financial reporting, the risk of fraud and misappropriation of assets. It also potentially reduces the cost of capital for audited companies by ensuring more transparency and reliability of financial statements.

Formulation of article aims. Developments in the field of audit aimed to identify the problems that we hope only partly contributed to the deepening of the recent crisis, or did not predict its appearance beforehand. While the role played by banks or supervisors has been questioned and analyzed in many instances during crisis, little attention had been given to the role of auditors. It is right that the role of auditors and accountants should be questioned. Despite the inquiries, no one has argued that audit itself is unnecessary. During past several years very important global changes took place in international legislative network of audit that aimed to strengthen the profession. The amendments were mainly connected with the problems concerned with auditor independence and report, fee for audit and non audit services, auditor rotation and market concentration. Particularly the start point of recent amendments in the field of audit was the year 2010. In the year 2010 “The Green paper: Lessons from the crisis” was issued by European Commission. It was created in order to open debate on the role of the auditor, the independence of audit firms, the supervision of auditors, the configuration of the audit market, the simplification of rules for Small and Medium Sized Enterprises and Practitioners [1].

The main material of research. It was right mentioned that nowadays current practice would seem to indicate that the reasonable assurance is less targeted at ensuring that the financial statements give a true and fair view and more geared to ensuring that the financial statements are prepared in accordance with the applicable financial reporting framework. The recent financial crisis has shown that audit opinions should focus on "substance over form". It is important to note that the International Financial Reporting Standards (IFRS) are based on the premise of the principles of true and fair view and substance over form [3]. The auditor’s report should be more detailed, which can be achieved by increased level of auditors skepticism and independence. The call for change initially came primarily from institutional investors and financial analysts who are looking to auditors to help assist in navigating increasingly complex financial statements and point out the areas on which the auditor’s work effort was focused particularly on the most subjective matters within the financial statements. Following to the discussions on paper it is important to clearly define what sort of information should be provided to stakeholders by the auditor as part of its opinion and finding. Nowadays stakeholders are expecting higher level of assurance and qualified audit reports. For carrying out these demands the auditor needs to play an important role by actively challenging management from a user's perspective. The potential consideration may be the extent to which information of public interest that is available to auditors should be communicated to the public. It is also important to consider the extent to which auditors should themselves provide an economic and financial outlook of the company. The issue was discussed and developed until the year 2012. The International Auditing Assurance

Standard Board issued an Invitation to comment: Improving the Auditor's Report. The international academic research on user perceptions of the standard auditor's report was commissioned. Findings from research, the input obtained from the dialogue with various stakeholders around the world mentioned that there was clear demand for auditors to provide greater transparency about significant matters in the financial statements, as well as the conduct of the individual audit. The board aspires to improve auditor reporting on a global basis, in the same way that it has worked to strengthen and harmonize the underlying work effort of audits through its clarified ISAs. It is vital to have a robust understanding of views about the value and viability of the options for change and how best to effect these changes globally. The deliberations have been guided by the following principles [7]:

- Change to the auditor's report must have value to users and be capable of being operationalised internationally.
- Users have asked the auditor to enhance their ability to navigate and better understand increasingly complex financial reports.
- More transparency is needed about key matters related to the audited financial statements and the nature of, and work performed in, an ISA audit.
- A revised auditor reporting standard must be capable of being applied on a proportionate basis to all entities.

Any new international auditor reporting standard must be capable of being implemented in diverse national environments. Accordingly, in developing its suggestions to improve the auditor's report, was identified common elements that would be required in all auditors' reports, while providing the flexibility for jurisdictions to further tailor auditors' reports, if appropriate. The new illustrative auditor's report has been prepared assuming IFRSs is the applicable financial reporting framework. In developing the illustrative report, it was used a value and impediments model to help evaluate and narrow options to those that it believes should be pursued.

The independence of audit firm is also one of the key issues for preparation of qualified opinion. The independence should thus be the unshakeable bedrock of the audit environment. It is clear to all that that independence is critical to the viability of auditing as a profession. One of the problems in this area is connected with mandatory rotation. Situations where a company has appointed the same audit firm for decades seem incompatible with desirable standards of independence. The aim of independence can be achieved if the audit firm changes on a regular basis. It gives a clear appearance of separation between the audit firm and the company and reduces the risk of bias or familiarity. Independence is vital to giving an objective opinion which is relied upon by investors. Firm rotation is a measure to achieve independence. In this context, the mandatory rotation of audit firms and not just of audit partners should be considered. Raised questions have been discussed in many international associations and other professional bodies at various times. In the year 2011 The Public Company Accounting Oversight Board issued concept released on auditor independence and audit firm rotation [4]. The concept release notes that proponents of rotation believe that setting a term limit on the audit relationship could free the auditor, to a significant degree, from the effects of client pressure and offer an opportunity for a fresh look at the company's financial reporting. Few among auditors, financial statement users would seriously dispute the value of independent assurance on a company's financial statements. The auditor independence remains subject to a significant inherent risk. It was reviewed portions of more than 2,800 engagements of such firms and discovered and analyzed several hundred cases involving what they determined to be audit failures. Other regulators have found similar problems. For example, according to a recent report, the UK Audit Inspection Unit found that "firms sometimes approach the audit of highly judgmental balances by seeking to obtain evidence that corroborates rather than challenges the judgments made by their clients." In reporting on its recent inspections of the Big Four accounting firms, the Netherlands Authority for the Financial Markets stated that it found weaknesses in 29 of the 46 audits it reviewed and identified "insufficient professional skepticism exercised by the external auditor" as one of the causes of these weaknesses. Some practitioners and researchers have stated that the cost of mandatory rotation would be high and the benefits that financial statement users might gain would be offset by the loss of benefits that result from a continuing relationship. Also they have mentioned that it would lower audit quality. Part of practitioners agreed that there is strong evidence that requiring the rotation of entire firms is a prescription for audit failure. It could expose the public to a greater and more frequent risk of audit failure. Also the research considers whether alternatives to mandatory rotation exist that would enhance independence and objectivity. As a possible approach to rulemaking was mentioned that should be prepared a rule providing that a registered public accounting firm is not independent of its audit client if it has provided an opinion on the client's financial statements for a certain number of consecutive years. Another fundamental decision is whether to consider a rotation requirement for all audits conducted pursuant to supervisor standards or whether to limit the audits to which the requirement would apply. For example, if the rule applies only to audits of the largest companies, it could minimize the costs of the rule, while preserving much of its benefits.

The further enlargement of audit networks creates another problem connected with concentration and market structure. In terms of the revenues or fees received, the total market share of Big Four audit firms for listed companies exceeds 90% in a vast majority of European countries. The market appears to be too concentrated and concentration might entail an accumulation of systemic risk. As a way of avoiding further concentration the it was suggested several activities including joint audits that are only enforced in France, where listed companies were required to appoint two different audit firms, who share the audit work and jointly sign the audit report. Also in November 2011 it was suggested amendments on Directive 2006/43/EC connected with auditor independence and market concentration[5]. The measures adopted in many countries aftermath of the financial crisis have mainly focused on the urgent need to stabilize the financial system. The proposals aim at enhancing the internal market for statutory audits to allow small and medium-sized firms to grow and encourage the entry of new players. The high degree of concentration in audit market and the multitude of approval procedures necessary to provide cross-border statutory audits prevent small and medium-sized audit firms from benefiting from the internal market. Suggested amendments introduce more stringent rules for the auditors and audit firms that are aimed in particular at strengthening the independence of auditors as well as at assuring greater diversity into the current highly-concentrated audit market. One of the important amendments of the directive concerned the liberalization of the ownership rules of audit firms. It has required that a majority of the voting rights in an audit firm is held by licensed accountant practitioners. This requirement is no longer stipulated in the proposed amendment and is forbidden to require that a minimum of capital or of voting rights in an audit firm is held by statutory auditors or audit firms.

In the year 2013, the EU agreed also concerning mandatory rotation of statutory auditors and audit firms of Public Interest Entities. The agreement includes the 10 years basic period after which country may allow the auditor or audit firm to continue audit of the same entities up to the maximum duration of 20 years where a public tendering is conducted and up to 24 years in case of a joint audit. There is no worldwide ban preventing auditors from offering non audit services to audit clients. Since auditors provide an independent opinion on the financial health of companies, ideally they should not have any business interest in the company being audited. Another issue was raised connected necessity of examination of reinforcing the prohibition of non-audit services by audit firms and limitation of the proportion of fees that audit firm can receive from a single audit client compared to the total audit revenues of the firm. Recent amendments in EU legislation also included the 70% cap for the fees from non-audit services provided by the audit firm for audited undertaking, and the agreement on the framework for audit oversight cooperation. It was also adopted that particular non-audit services for audited public interest entities will be prohibited, but countries have the right to allow some tax and valuation services to be provided if they are immaterial and have no direct effect on the audited financial statements.

Mentioned problem is also highlighted in the reality of Armenian audit market. The audit market of the republic of Armenia is growing rapidly. Together with increasing efficiency there is a increasing level of risk for further market concentration. For evaluation of effectiveness of audit market a common indicator was calculated based on the following financial ratios:

1. the ratio of profit to cash from main activities (R1),
2. the ratio of cash from main activities to total cash inflow (R2),
3. the ratio of total cash inflow to total income (R3),
4. the ratio of total income to total expenditures (R4),
5. the ratio of total expenditures to total assets (R5),
6. the ratio of equity multiplier (R6),
7. the ratio of own capital to cost on good sold (R7),
8. the ratio of cost on good sold to sales (R8)

Table 1

The common ratio of effectivness of audit companies

	R1	R2	R3	R4	R5	R6	R7	R8	Total
2010	0.128	0.888	0.762	1.095	2.148	3.236	0.254	0.588	0.098
2011	0.220	0.893	0.757	1.175	2.483	2.689	0.231	0.524	0.141
2012	0.222	0.890	0.760	1.180	2.420	2.712	0.240	0.562	0.156

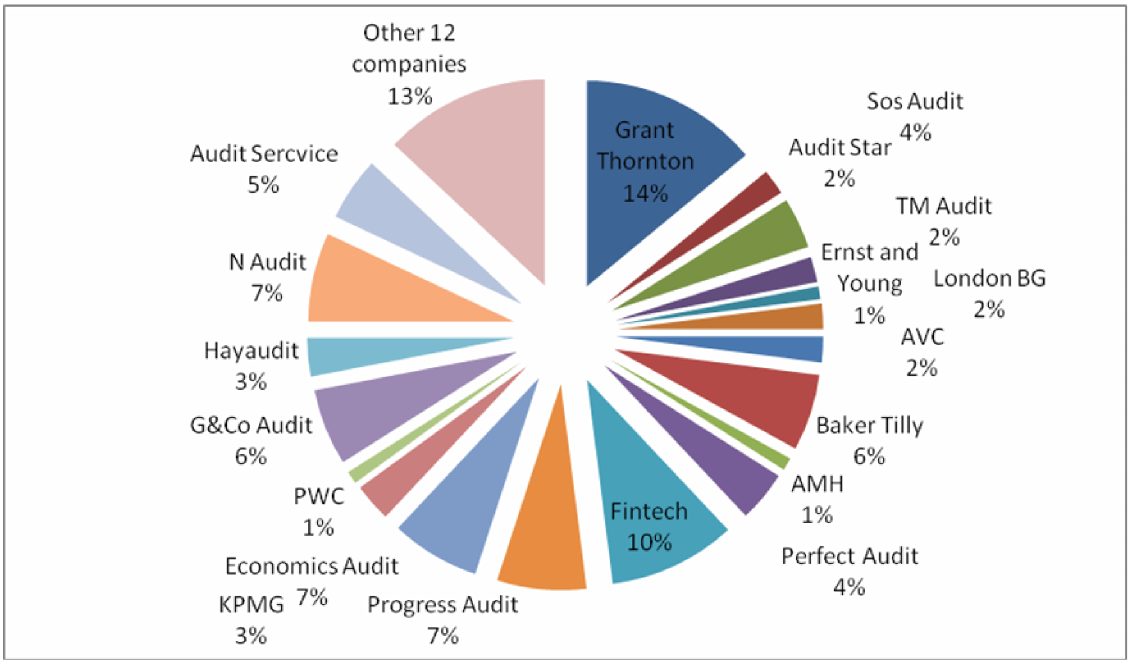
It is obvious that the level of effectiveness is growing year by year, but there is no evidence that the effectiveness contributes to the formation of a competitive market.

The released data of audit companies of Republic of Armenia about audited organizations in the year 2013 gave an opportunity to determine the level of participation of companies in the structure of audit market.

In the year 2013 there were 32 licensed auditing organizations in the Republic of Armenia. The figure was mainly the same in the year 2012. About 900 large companies were audited in the year 2013.

Picture 1

Structure of Audit Market of the Republic of Armenia by audited companies (%)



The high level of concentration is mainly connected with audit of financial sector organizations. From 32 licensed audit companies only 12 provide professional auditing services to financial organizations. Most preferable audit companies were not domestic, but international organizations. Particularly leading position belongs to 3 companies: KPMG Armenia, Grant Thornton, Baker Tilly Armenia.

This fact cause a main concern because financial sector is playing a significant role in ensuring financial stability and further concentration may cause systematic risk or at least create dominant position of several companies in financial services sector.

According to data of the year 2013, the above mentioned 3 companies cover 57.8% of audit market total revenue. It turns out that the relevant audit market is mainly covered by 3 audit companies and this process is continuous. The continuous process indicates the fact that there is a concentration risk in audit market.

For measuring the concentration level of audit market Herfindahl-Hirshman Index (HHI) was used. "HHI" stands for the Herfindahl-Hirschman Index, a commonly accepted measure of market concentration. It is calculated by squaring the market share of each firm competing in the market and then summing the resulting numbers.

The results for the years 2011 and 2012 are following:

Table 1

Herfindahl Hirshman Index (HHI)

	HHI (Income)	HHI (Capital)	HHI (assets)
2011	0.17 (1703)	0.16 (1615)	0.14 (1418)
2012	0.14 (1413)	0.12 (1290)	0.11 (1170)

The figures show that the concentration index is reducing but it is still on the top of accepted average level.

Audit rotation provides wider range of audit firms' access to audit opportunities. Mandatory rotation means more opportunities for firms of all sizes to tender. Smaller audit firms may be able to obtain more work in other areas if larger firms restrict providing other services to make themselves available for audit. This problem has not solved in the Republic of Armenia yet. Market centralization should be reduced by several legislative activities. One of the good solutions can be restriction of the possibility of the formation such concentration, which can achieved relatively by mandatory rotation of audit companies.

Conclusions. Concluding above discussed problems we can state that contribution of auditing in the economic development is correlative to the role, independence and function of auditor. Broadly, the better the role and independence is fulfilled, the greater the contribution is. For this reason, clarifying and better understanding of the current problems of auditing is imperative for understanding of insights of the contribution of auditing in the economic development of each country.

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