February 21, 2024

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Re: Request for Public Comment on 2024's *Notice of Changes to the State Audit Rule*

During our review of the Notice of Changes to the State Audit Rule, we noted that the State Auditor's Office is proposing the following amendment; "amend and shortens the auditor rotation rule from eight (8) to six (6) years". We would like to provide our viewpoint and comment on this proposed change.

Changing the Rotation Rule from an 8-year Interval to a 6-year Interval will Contribute to the Following Adverse Issues

- Lower quality audits — Shorter rotation rules increase the risks associated with first-year audits. Auditors adhere to rigorous standards and the transition period during the initial year will pose additional challenges. With a shorter rotation period, the frequency of first-year audits will increase and audit firms will have more first year engagements in their total book of business. Therefore, firms will be required to do more work in the same amount of time due to state audit rule deadlines. This will put pressure on audit firms and incentivize lower quality audit work.

- Increase in late audits — The increase in workload by both the Agency and audit firms will not only increase the likelihood of substandard audits due to the learning curve involved but will prolong the audit process, heightening the risk of delays, regulatory penalties, and erosion of stakeholder confidence.

- Higher costs — Initial procedures to "understand the entity" such as gaining information about its systems and processes require more time and effort. This extra time by the Agencies to provide information and extra time for the Audit Firm to document the information, translates into higher costs. These initial costs are usually considered to be investments by the audit firm. Shortening the rotation rule will result in firms having to pass on the costs to the Agency.

Maintaining the 8-year Rotation Rule will Continue the Following Advantages

- Stability fostering audit quality — A longer tenure, yet there is still rotation, will allow auditors to develop a solid understanding of the organization's intricacies, fostering stability and continuity, essential for maintaining audit quality. Economically, continuing the 8-year rotation period proves advantageous, for both the auditor and Agency, as it curtails the initial start-up costs associated with new auditors acquainting themselves with the organization. This move towards cost efficiency is particularly crucial given the resource-intensive nature of audits, on both the auditor and the Agency.

- Timely audits — Finally, fewer first-year audits will lower the risk of late audits. Late audits can have serious implications, including regulatory penalties and a loss of stakeholder confidence. By continuing the existing 8-year rotation period, the frequency of higher-risk first-year audits is reduced, thereby enhancing the overall reliability and timeliness of the audit process.

Mitigating Risks and Ensuring Quality and Independence

There have been some strong arguments for rotation of audit firms, which are motivated by the public's desire for high quality independent audits. The fundamental arguments are:

1. Extended auditor tenure encourages complacency between the audit firm and the Agency, thereby diminishing the independence, objectivity, and professional skepticism of the audit team.

    - This risk is mitigated by robust oversight mechanisms such as the Office of the State Auditor's workpaper and report reviews and Department of Finance and Administration's report reviews. These measures, along with rigorous auditor independence standards, ensure that audit quality remains uncompromised over time.

- Additional steps can be taken to reduce the risk:
    - Further emphasis on training Agencies in the adoption of internal control best practices, including documentation of these controls so they can be easily referenced by the Agency and their auditors.
    - Further training of Agencies in understanding their responsibilities in overseeing non-attest services, such as cash to accrual conversions and preparation of financial statements and note disclosures.
    - Further emphasis on establishing audit committees that meet directly with auditors.
    - Encourage and incentivize audit firms and Agencies to perform higher quality audits.

2. Higher frequency of rotation will spur competition between audit firms that will improve audit quality.
    - This argument has not been substantiated. On the contrary, higher rotation rules also carry the risk that audit fees will be undercut due to competition, which leads to lower quality audits.

Research Supports the Drawbacks of High Frequency Rotation

Several studies and articles shed light on the drawbacks of frequent auditor rotation and independence.

- A study published in the American Accounting Association Journal '*Auditing: A Journal of Practice and Theory*' found no significant improvement in audit quality in the first year or two following rotations. In fact, some evidence even suggested a decline in audit quality with a new engagement partner, possibly due to a decrease in knowledge about the client.[1]

[1] https://www.cpapracticeadvisor.com/2020/09/24/should-u-s-broaden-mandate-on-auditor-rotation/40389/ and Kuang, Huan and Li, Huimin and Sherwood, Matthew and Whited, Robert Lowell,

- Opponents of mandatory rotation argue that substandard audits occur more frequently for newer clients because auditors have less information about these organizations[2]. Additionally, newly appointed auditors, concerned with recovering startup costs, may be more easily influenced by the client during the early years of an audit engagement[3].

- A report by the U.S. Government Accountability Office (GAO) found that almost all of the largest public accounting firms and Fortune 1000 publicly traded companies believe that the costs of mandatory audit firm rotation are likely to exceed the benefits.[4]

- A study conducted in 2004 by professors Joseph Carcello and Albert Nagy noted they failed to find evidence that fraudulent financial reporting is more likely given long auditor tenure. They noted their results were consistent with the argument that mandatory audit firm rotation could have adverse effects on audit quality.[5]

- Academic studies also show that the risks to audit quality tend to be higher in the initial one or two years of an engagement and the likelihood of restatements diminish as auditor tenure increases. [6] [7]

Mandatory Audit Partner Rotations and Audit Quality in the United States. Auditing: A Journal of Practice & Theory, 2020, Vol. 39, No. 3, 161-184, Available at SSRN: https://ssrn.com/abstract=4015561

[2] Randal J. Elder, Suzanne Lowensohn, Jacqueline L. Reck; Audit Firm Rotation, Auditor Specialization, and Audit Quality in the Municipal Audit Context. *Journal of Governmental & Nonprofit Accounting* 1 December 2015; 4 (1): 73–100. https://doi.org/10.2308/ogna-51188

[3] https://www.cpapracticeadvisor.com/2020/09/24/should-u-s-broaden-mandate-on-auditor-rotation/40389/

[4] United States Government Accountability Office, Report to the Senate on Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services: Required Study on the Potential Effects of Mandatory Audit Firm Rotation, GAO-04-216 (Nov. 2003)

[5] J.V. Carcello & A.L. Nagy, *Audit Firm Tenure and Fraudulent Financial Reporting*. AUDITING: A JOURNAL OF PRACTICE AND THEORY, Vol. 23, Issue 2 (Sept. 2004).

[6] See, e.g., A. Ghosh and D. Moon Auditor Tenure and Perceptions of Audit Quality, THE ACCOUNTING REVIEW, Vol. 8, No. 2. (2005); J. Blouin, B. Grein, & B. Rountree, An Analysis of Forced Auditor Change: The Case of Former Arthur Andersen Clients, THE ACCOUNTING REVIEW, Vol. 82, No. 3 (May 2007).

[7] J. Stanley & F. DeZoort, Audit Firm Tenure and Financial Restatements: An Analysis of Industry Specialization and Fee Effects, JOURNAL OF ACCOUNTING AND PUBLIC POLICY (Mar. 2007).

In conclusion, maintaining the auditor rotation period at 8 years presents a compelling case for enhanced stability, quality, timeliness, and cost efficiency in audits. By continuing the 8-year frequency of rotation, New Mexico's audit system stands to preserve many advantages in its effectiveness and uphold the standards of audit quality. Furthermore, it can explore enhancements in training and oversight, thereby increasing the overall quality of audits.

We thank you for the opportunity to submit a comment regarding this matter.

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