Introduction

The debate on the impact of long term auditor/client relationships on the quality of financial statements has been ongoing for years. Even the U.S. Senate convened hearings on the subject as early as 1976 (Dao, Mishra, Raghunandan, 2008). A study conducted by the Fulcrum Financial Group in 2003 (Arel, Brody, Pany, 2005) noted that the average tenure for audit firms of Fortune 1000 companies was 22 years with 10% of these companies having the same auditors for 50 to 75 years. Over the years, numerous studies have been conducted to determine whether auditor tenure had a direct correlation to financial statement quality. Findings supporting and rejecting the concept of mandatory auditor rotation have resulted from these studies.

In August of 2011, the Public Company Accounting Oversight Board (PCAOB) issued a concept release that proposed mandatory auditor rotation for all publicly traded companies. The purpose of the concept release was to solicit comments from interested parties regarding requiring publicly traded companies to rotate independent auditors. In response to PCAOB’s action, in July 2013, the U.S. House of Representatives passed H.R. 1564, The Audit Integrity and Job Protection Act (Cohn, 2013). This bill prohibits the PCAOB from requiring mandatory auditor rotation. Introduced by Representatives Hurt (R-V.A.) and Meeks (D-N.Y), the bill was passed by a vote of 321-62 and has been sent to the Senate for consideration. The reasons given by the authors of the bill were to protect jobs and to minimize the role of the Federal government in the affairs of publicly traded companies. It appears, at least from the actions of the U.S. House of Representatives, that the need for jobs outweighs the need to protect the shareholder.

Of interest is the fact that legislators have voiced concerns for years about the impact of auditor tenure on the quality of financial statements (Dao, Mishra, Raghunandan, 2008) and now appear content to dismiss the issue for political purposes. As recently as 2002, Congress passed the Sarbanes-Oxley Act (SOX) wherein section 207 required the Government Accountability Office (GAO) to study mandatory auditor rotation (Chi, 2011). The GAO did perform such a study but concluded that there was not sufficient information to recommend one way or another (Franzel, Vagnoni, 2004) and recommended that the effects of other sections of SOX be identified first before a decision is made on mandatory auditor rotation.

This author believes that the debate should continue. SOX is now eleven years old and the effects of the various provisions of the act on audit quality can be identified. It is now time to evaluate the impact of auditor rotation on the quality of the financial statements and end the debate. There have been many approaches to measurement of the impact of auditor rotation.

Literature Review

The U.S. economy continues to improve since the 2008 economic downturn. This improvement is based, in part, in the regulatory oversight and assurance of the quality of the financial information provided by publicly traded companies (Kueppers, Sullivan, 2010). However, accounting scandals continue to be disclosed subsequent to SOX—Satyam Computer Services, Lehman Brothers, and Olympus Corporation to name a few.
Independent audits provide a basis for the confidence in the financial statements and serve to contribute to investor confidence (Kueppers, Sullivan, 2010). Key to the role of the accounting profession is the providing of a quality audit (Wines, 2012). To provide a quality audit, an auditor must be independent from the client being audited in both fact and in appearance (Wines, 2012). Without the appearance of independence, the quality of the financial statements is put in jeopardy. However, independence is subject to individual perspectives and can be misunderstood. In an attempt to minimize any misunderstandings, rather than defining independence, the American Institute of Certified Public Accountants in their Code of Professional Conduct, has identified activities that would cause an auditor not to be independent (AICPA, 2013). While definitions of auditor independence may be subject to debate, the issue is that independence is a key component of a quality audit and is central to the building of confidence in the quality of a company’s financial statements (Wines, 2012).

One aspect considered potentially important for auditor independence is the concept of auditor rotation. Over the years several studies have reviewed the effect of changes in auditors on the financial operations of a company, the quality of a company’s financial statements, the cost of the audit, and the price of a company’s stock. Findings included stock price declines of clients of Arthur Andersen after announcement of the Enron scandal, auditor fees for non-audit services declined after an auditor switch, audit fees decreased in the first year after a switch even though audit quality and audit hours increased during the first year after the switch, generally audit fees increased for changes in audit firms from small firms to larger firms, stock prices declined when there was a combination of an auditor’s resignation and a disclosure about a disagreement with management, and it has been found that turnover of Chief Executive Officers and Chief Financial Officers increase after auditor resignations (Stefaniak, Robertson, Houston, 2009).

Other studies found that auditor conservatism had a direct relationship to client initiated changes in auditors. The more conservative position the auditing firm took on a specific issue, the more likely the client switched auditors (Stefaniak, Robertson, Houston, 2009). Additionally, bond ratings declined after changes in auditors (Stefaniak, Robertson, Houston, 2009).

More recently, research specifically related to mandatory rotation has had mixed results. Some studies indicate improvement in audit quality while other studies indicate loss of quality (Stefaniak, Robertson, Houston, 2009). As cited in Stefaniak, Robertson, Houston (2009), Gietzmann and Sen (2002), Nagy (2005), and Dopuch et al. (2001) identified improvement in audit quality and reduction of biased financial reporting in favor of management as a result of mandatory auditor rotation. Additional citings in Stefaniak, Robertson, Houston (2009) including Imhoff (2003) and Daniels & Booker (2005) explored the impact of rotation of auditors on the perception of independence and found a positive correlation.

However, other studies found that mandatory auditor rotation would have negative impacts on quality. Geiger and Raghunandan (2002) observed a higher number of errors on financial reports issued by shorter tenure auditors than longer tenure auditors. Carcello and Nagy (2004) noted in their study that fraud in financial statements appeared to decrease as tenure of the auditor increased. And Gosh and Moon (2005) found that investors’ perception of audit quality increased with auditor tenure.
A recent study by (Chi, Lisic, Pevzner, 2011) dealing with companies managing earning revealed that companies shifted from using accruals to engaging in operational decisions to manage earnings (real earnings management) when the tenure of the independent auditor increased. Chi, Lisic, Pevzner (2011) noted that companies would manage earnings by taking operational actions in the short-term that would have negative long term impacts on earnings in the long-term. These actions were the direct result of switching from using accruals to actual operational decisions to achieve the desired financial results. The cause of this switch was attributed to auditors that demonstrated conservative values and questioned the use of accruals. It was determined by Chi, Lisic, Pevzner (2011) that tenure and expertise of the auditor created their conservative positions and mandatory rotation could potentially reduce real earnings management.

Another study performed by Chi (2011) focussed on the effect of mandatory rotation on monitoring efforts by the audit committee. In this study, Chi proposed that mandatory rotation of the company auditors requires the audit committee to be more involved with and to more aggressively monitor the audit process. This action will cause the audit committee to be more concerned with the audit strategy, more sensitive to potential conflicts, and more immersed in the entire audit process. Additionally, mandatory rotation eliminates the rewarding of acceptable behavior, developing too close of a relationship with company decision makers, and becoming overly familiar with company operations thus causing the audit process to be flawed because the audit team has lost its professional skepticism.

Opponents of mandatory rotation cite that auditors have to spend time to learn the client’s systems and processes (Chi, 2011). An ongoing relationship helps to develop a greater understanding and therefore aids in the identification of accounting irregularities. It is argued that returning auditors become more efficient in their audit process as time goes on (Arel, Brody, Pany, 2005), and this benefits the client through less disruption to daily operations. Some countries that have adopted mandatory auditor rotation rules have subsequently dropped them (Spain and Turkey) while Italy has retained them but reports that the rules are detrimental to audit quality but improves public confidence (Arel, Brody, Pany, 2005).

The determination of quality of audits, as a group, is difficult as data does not exist that measures high or low quality (Ronen, 2010). Empirical studies to date have focused on a variety of measures to determine audit quality. Ultimately, however, it’s the investor that must be satisfied and feel comfortable. Dao, Mishra, & Raghunandan, (2008) found that shareholders are less likely to vote for auditors with long tenure because of the perception that the auditor is losing independence. The perceptions of the investor affect the confidence of that investor. And without investor confidence, our capital markets are at risk (Dao, Mishra, Raghunandan, 2008). Auditor independence has been determined by past studies to be a critical component of the investor’s confidence and if independence is questionable, the investor will be less likely to invest in the company’s securities (Dao, Mishra, Raghunandan, 2008). The result is a lowering of the price of the company’s securities.
Conclusion

If audit firm rotation can influence auditor independence, then aggressive reporting of financial results should be reduced as it has been found in previous studies that rotation of auditors causes more conservative reported earnings than longer tenure auditors (Kramer, Geogakopoulos, Sotiropoulos, Vasilelou, 2011). One purpose of SOX was to improve the independence of auditors so that management would have less influence on auditors’ actions. Mandatory rotation of the lead audit partner was a step in the direction toward the concept of mandatory audit firm rotation. If the intent of SOX is achieved, as it relates to auditor rotation, the shareholder should experience a more conservative reporting of financial results and therefore obtain a level of comfort with the quality of the financial reports issued by publicly traded companies. An independent auditor, in fact and in appearance, provides the investor with a level of comfort that the financial statements are reasonably accurate and reflect the financial results of the company. As financial reporting evolves to meet the needs of the users, so too must the concept of independence evolve to assure that the financial results being reported reflects the proper financial results in an unbiased manner consistent with the intent of the rules governing the creation of those financial statements.
Bibliography


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