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Mandatory Audit Firm and Audit Partner Rotation

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Abstract

Mandatory audit partner and audit firm rotation are important part of audit quality component. Some regulators and scholars believe that auditor rotation shows auditor's independence in the audit context. In order to achieve high audit quality, most of the researchers agree on as a result of auditor rotation, the financial reporting and the audit quality will be enhanced owing to auditor's independence. This study reviews the recent years with respect to audit partner rotation, the audit firm rotation and audit quality as well as recognizing overlook in the literature where future studies are needed to be done. Based on recent studies, both audit firm and audit partner rotation enhance and improve audit quality, as high audit quality increases the transparency of financial reporting.

Keywords: Audit firm rotation, Audit partner rotation, Audit quality

1. Introduction

In the new global economy, audit quality has become a central issue for governments, regulators and other stakeholders. The responsibility of auditor's independence has been an object of research after failure of Enron, WorldCom and other corporate scandals. These collapses quickly encouraged regulators to ponder some mechanisms for increasing auditor's independence. Proposing an audit partner and a mandatory audit firm rotation to reduce familiarity between auditors and their clients in enhancing audit quality as well as auditor independence is decided by the regulators. The main argument against mandatory auditor rotation contemplates that when the auditors engaged in the first year, audit quality might be inferior because of absence of new auditor's knowledge regarding their clients (Carcello & Nagy, 2004; B. Daugherty, Dickins, & Higgs, 2010). In the light of the above discussion, the main objectives addressed in this paper are: 1) preparing an overview of the audit partner and audit firm rotation on audit quality and 2) other countries also use this role in improving their audit quality.

Reviewing recent research into the mandatory audit firm and audit partner rotation in several countries, such as developed and developing country, is the basic purpose of this study. This research contributes to audit literature by two issues; the impact of mandatory audit firm rotation (MFR) and mandatory audit partner rotation (MPR) on audit quality. These two issues re-entered recently in the European Commission (EU) and the Public Company Accounting Oversight Board (USA).This study first gives a brief overview of the recent history of debate on mandatory audit partner and audit firm rotation, the second part shows evidence in practice and finally, the last part presents the conclusion and recommendations for future studies.

2. Debate on Mandatory Audit Firm and Audit Partner Rotation

Both researchers and regulators believe that the cause of many corporate scandals and collapses are the result of auditor's independence, while the main goal of auditor rotation at the level of firm and partner is auditor's independence. As per regulators' consideration, due to the tenure of auditor and partner, they get too familiar in the long term with their clients and auditors are most likely to compromise on reporting and accounting choices of their client. Therefore, the advocates of compulsory auditor rotation believe that introducing a maximum number of years (limitation) may improve the independence of auditing and audit quality.

There are some arguments within proponents and opponents for auditor rotation in partner and at firm's level. From the proponent's perspective, the first main argument is independence of auditors. They believe that with mandatory audit rotation, the independence of auditor increases and leads to high audit quality(Lennox, Wu, & Zhang, 2014), thus it avoids and reduces audit failures (Casterella & Johnston, 2013). Therefore, by recognizing the minimum and the maximum length of tenure, the auditor will be forced to pay attention to the details and be more skeptical in their audit approach. They believe that long tenure between auditor and client lead to excessive familiarity between them and impair independence of auditors (Casterella & Johnston, 2013; Catanach Jr & Walker, 1999; Firth, Rui, & Wu, 2012; Stefaniak, Robertson, & Houston, 2009). Most analytical studies support a positive effect between auditor rotation and audit quality (Carcello & Nagy, 2004; B. E. Daugherty, Dickins, Hatfield, & Higgs, 2012, 2013; Firth et al., 2012; Harris & Whisenant, 2012). In contrast, the ombudsmen of

mandatory auditor rotation belief that in the extended term, the auditors are in close association with the company and in congruence with the board on reporting and the rotation of auditors would have a positive effect on audit quality (Ewelt-Knauer, Gold, & Pott, 2013). The second argument for mandatory auditor rotation is, opponents believe that the smaller audit firm has the opportunity to participate due to enhanced competition of the market (Carrera, Gómez-Aguilar, Humphrey, & Ruiz-Barbadillo, 2007; Ewelt-Knauer, Gold, & Pott, 2012; Ewelt-Knauer et al., 2013; Jackson, Moldrich, & Roebuck, 2008).

The main perspective of opponents considers that cost of mandatory auditor rotation is more than its benefits such as set-up costs of new auditors to recognize the new client's model, losing of client-specific information and structure of the organization and also believe that audit partner rotation does not improve quality of audit where audit markets are highly focused with a handful of large audit firms controlling the market (Bandyopadhyay, Chen, & Yu, 2013). They believed that cost of audit firm rotation is in excess of audit partner rotation. The new audit firm brings a new audit team, as a result of audit firm rotation and also uses an extra new client procedure with new audit methodology. However, in audit partner level only the audit partner changes and new audit partner use and follow previous working papers, audit methodology and history of the firm related to the client (Chen, Lin, & Lin, 2008; B. E. Daugherty et al., 2013). Second perspective considers that audit fees will be enhanced when the mandatory auditor rotation occur because it forces the auditor and client relationship into a restricted period, so that they will enhance the audit's initial fees due to dearth of audit firm who are willing to offer low fees initially (Chi, 2005; DeAngelo, 1981). Also, the loss in the charm of audit profession is one of the negative features of audit firm rotation (KPMG LLP, 2010). In this situation, auditors concern about rising in indecisiveness relating to capacity of audit prerequisites and where to find best capable personnel with specific expertise (Ewelt-Knauer et al., 2012).

For mandatory auditor rotation, there are some insights from auditors, regulators, shareholders and audit clients. The regulators consider that the audit quality decreases with the increase in the tenure of the audit firm. This diminishes the quality of audit affected by acquaintance with the management and absence of devotion to staleness and redundancy. PWC (2007) contended that after the mandatory audit firm rotation occurs, auditor's association with the company will be reduced. In contrast, auditors suffer the risk of audit failure, which enhances by mandatory audit firm rotation for the period before auditors are capable of developing particular information about the company (Capitol Federal Financial Inc., 2011). However, on mandatory audit firm rotation, managers have diverse opinions. Some companies' management belief that once the new auditors engaged in the client company, the staff tends to be much earmarked towards them and fraud exposure (Johnson Kolawole Olowookere & Adebiyi, 2013). Lastly, there exists a perspective of shareholders towards mandatory audit rotation. They consider that in the mandatory auditor rotation, investors may not be able to separate voluntary audit firm rotation to mandatory audit firm rotation owing to enhanced information cost(Bigus & Zimmermann, 2007).

The American Institute of Certified Public Accountants (AICPA) in 1992 issued a report about "statement of position regarding the mandatory audit firm rotation of public companies." The AICPA absolutely disagrees about this role because they consider that if mandatory audit firm rotation happens, the public will not be interested in these changes. AICPA examines over 400 audit failure cases during 1991 to 2010 and showed that most of the audit failures occurred when the auditors were carrying out their second or first audit of a company. The study also suggested that requiring mandatory audit rotation would enhance audit failure risk and with changing audit firm, the auditors will not have sufficient knowledge of the new client's business (AICPA, 2011). Table 1 shows the summary of the arguments between opponents and proponents about compulsory auditor rotation.

Table1. Summary of arguments between proponents and opponents about mandatory audit rotation

Proponents of mandatory auditor rotation	Opponents of mandatory auditor rotation
Enhance auditor independence	Cost of mandatory auditor rotation is more than its benefits
Enhance audit quality	Enhance audit failures due to lack of new auditors knowledge about the client
Independence in appearance	Auditor rotation is not in the interest of public
Opportunity comes smaller audit firms to market	Allowed smaller audit firms enter easily to market

3. Mandatory audit firm and audit partner rotation

The role of auditor rotation is different in each country. In a number of countries, all listed companies, have a mandatory auditor rotation and some of them only confined to particular sectors, such as, an insurance industry (Iceland, Pakistan and Slovenia), banking industry (Brazil), financial institution (China, Ecuador, Iceland and Pakistan) and government companies (Oman and Peru). Pakistan, Italy and Oman in the past have required mandatory audit firm rotation for all of the listed companies. In Italy and Spain, all listed companies require changing of external auditor maximum of three year term (or nine total years). Pakistan consequently restricted this requirement to only for insurance companies and financial institutions. Many countries have adopted a mandatory auditor rotation before the collapse of Enron, such as France (1998) and Germany (1995).

Other countries such as Australia, Denmark, Cyprus, Finland, France, Germany, Greece, Japan, Malaysia, Singapore, Taiwan, UK and US do not have any regulation about audit firm rotation. For instance, in Malaysia regulators such as Bursa Malaysia and Securities Committees have emphasized more on the audit firm rotation after the corporate scandals in the U.S. Conversely, in Malaysia, in May 2002, the accounting governing bodies, for instance the Malaysian Institute of Accountants and the Malaysian Institute of Certified Public Accountants considered the audit rotation but only limited to the audit partner's rotation. They agreed to disadvantages of mandatory audit firm rotation such as cost of exorbitant and losing accumulative knowledge. Consequently, the establishment of audit firm rotation could not be sustained. Therefore, in Malaysia the audit partner rotation defines that audit partner has to change and rotate every 5 years for listed companies in Bursa Malaysia. In the case of audit firm rotation, it has not yet been adopted.

In summary, audit rotation came to existence after corporate scandals and corporate failures motivated by the public concern about auditor's lack of independence. In some countries such as Spain, auditors of failed companies were criticized for their poor audit quality. Table 2 demonstrates a complete synopsis of audit partner rotation and mandatory audit firm rotation in some countries.

Table2. Overview of mandatory audit firm and partner rotation for some countries

Country	Audit firm rotation	Audit partner rotation	Country	Audit firm rotation	Audit partner rotation
Australia	No	Yes, since 2001	Italy	3 years (total 9 years)	No
Belgium	3 years	Yes, 6 years	Japan	No	No
Brazil	5 years for non-bunk listed companies	No	Malaysia	No	Yes, 5 years
China	5 years of financial institution and state-owned entities	Yes, 5 years	Oman	4 years for listed, privet joint stock and government controlled companies	No
Cyprus	No	Yes, 7 years	Pakistan	5 years of financial and insurance companies	No
Denmark	No	Yes, 7 years	Peru	2 years for government companies	No
Ecuador	5 years of financial institution, 6 years for insurance companies	No	Singapore	No	Yes, 5 years
Finland	No	Yes, 7 years	Spain	3 years (total 9 years)	No
France	No	Yes, 6 years	Slovenia	5 years of insurance and investment management companies	Yes, 7 years
Germany	No	Yes, 7 years	Taiwan	No	Yes
Greece	No	Yes, 7 years	UK	No	Yes,5 years
Iceland	5 years of financial institution and insurance companies	No	US	No	Yes

4. Conclusion and recommendations for futures studies

Debates on audit firm and audit partner rotation arise from the arguments that long-term close relationship between management and the auditor would lead to audit failure and poor audit quality. A lot of arguments have

been made regarding the pros and cons of mandatory audit firm and partner rotation. Previous literature only focused on effects of audit partner and firm rotation rather than costs and benefits of rotation, and also it did not emphasize on specific costs and benefits of this regulation because of dearth of data. When the audit firm or partner changed, there are some costs that the company has to meet due to this issue, therefore it is useful to recognize and also analyses to what extent the audit rotation at the levels of partner and firm leads to the benefit of the company. Also, scholars should recognize the benefits and costs of rotation separately as they are quite different. Therefore; first, further research should examine specific costs and benefits of mandatory audit rotation at the levels of partner and firm. Second, future studies should investigate in those countries that do not have any role for mandatory audit firm rotation as well as audit partner rotation and search for which characteristics can affect the rotation of the audit partner and the firm. Third, future studies should also use other measurement and proxies for audit quality to demonstrate whether those measurements can affect and improve audit quality or not.

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