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# Mandatory Audit Firm and Audit Partner Rotation

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Mandatory Audit Firm and Audit Partner Rotation

Honor Thesis

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**Introduction**

Mandatory audit partner and firm rotation are always considered to be two efficient and effective approaches to ensure the independence of auditors and then improve audit quality at the same time. Audit quality has become one of the major issues which stakeholders, governments and policy makers most concern, which not only opens a door for the discussion of mandatory audit partner and firm rotation, but also brings them to center of the stage. However, there have been different arguments from both proponents and opponents for both mandatory audit partner and firm rotation for a very long period of time.

The proponents usually consist of different policy makers and governments. The first argument is that if the relationship between the client and audit partner/firm getting closer and closer after a long audit tenure, it is very likely that there will be a familiarity threat that creates negative influences on the judgment, which means the likelihood of making decisions that are different from those in the prior year will be very low. The second argument is that the implementation of mandatory audit partner and firm rotation will bring fresh perspectives to decrease the likelihood of auditors issuing inappropriate opinions only for satisfying their clients. The third argument is that the longer the audit tenure, the higher the likelihood of auditors having an economic dependence. The fourth argument is that the auditors will feel over confident in understanding the accounting practices of the client, which increases the likelihood of missing certain important tests for different assertions (Sayyar et al., 2014).

The opponents usually consist of audit firms and their clients. The first argument is that the departing audit partner/firm will not perform the audit engagement with high quality due to the absence of the incentive to be reappointed in the last year of audit tenure. The second argument is that the audit fees at the beginning of audit tenure will be increased by the additional

working hours and high startup costs. The third argument is that there will be a learning curve effect on the new incoming audit partner/firm, which will bring negative influences on the audit quality in the first couple years of audit tenure. The fourth argument is that there will be a lack of specific client information due to information asymmetry between the new incoming audit partner/firm and the client, which will bring negative influences on the capability of finding high risk areas in financial reports. The fifth argument is that the implementation of mandatory audit partner and firm rotation will exclude the audit partner/firm that is most qualified for some specific audit engagements at the very beginning (Sayyar et al., 2014).

Different countries choose to implement different types of mandatory audit rotation. The countries which choose to implement the regulation of mandatory audit partner rotation include Australia, China, Denmark, Finland, France, Germany, Greece, Malaysia, Singapore, United States, and United Kingdom. The countries which choose to implement the regulation of mandatory audit firm rotation include Brazil, Iceland, Italy, Pakistan, Peru, and Spain (Sayyar et al., 2014).

### **Australia**

Prior to December 2003, audit partner rotation was implemented in Australia only voluntarily. This policy was introduced in Australia to improve confidence of the public and investors. The issue of Professional Auditing Statement F1: Professional Independence in May 2002 was the first reform of this policy, and then it became effective later December 31, 2003. This new rule not only established mandatory audit partner rotation requirements for listed entities in Australia, but also set up the period to resume those requirements. It required mandatory rotation of the lead partner in every audit engagement every seven years, and a cooling-off period of no less

than two years. Subsequently, both the Corporate Law Economic Reform Program 9 legislation, which was issued in September 2002, and the revision of F1, which was issued in December 2004, became effective later July 1, 2006 and brought the second reform of audit partner rotation. They further tightened the policy to require mandatory rotation of both the audit review partner and lead partner in every engagement every five years (Ryken et al., 2007).

Monroe and Hossain (2013) examined the relationship between audit quality and audit partner tenure after mandatory audit partner rotation was implemented by using data from a period after that implementation. They first used the likelihood of auditors issuing going concern opinions to companies that were distressed financially as a measurement of audit quality. Then they developed a non-directional hypothesis that stated there was a significant relationship between audit quality and audit partner tenure. The research was started by selecting a sample. Because CLERP 9 legislation became effective after July 1, 2006, they targeted the annual financial reports that were prepared for the financial year after that day, and used data of audit opinion and financial statement from companies that had a balance sheet date from July 1, 2006 to June 30, 2010. Moreover, they hand collected audit opinion and partner data from the Connect4 and AspectHuntley DatAnalysis databases, and downloaded financial data from the AspectHuntley FinAnalysis database. They started with a sample of 7,196 firm-year observations. They defined financially distressed companies by looking at if they had negative operating cash flows and profit after tax in the given year, and narrowed the sample by excluding 2,231 firm-year observations of non-distressed companies. They also further narrowed their sample by excluding 254 firm-year observations of missing data, which resulted a final sample of 4,711 firm-year observations. In order to test the hypothesis, they chose the logistic regression model to predict the going concern opinions. As a result, Monroe and Hossain (2013) found that

there was a positive relationship between audit quality and audit partner tenure after the implementation of mandatory audit partner rotation, which indicated that the implementation improved audit quality.

Stewart, Kent, and Routledge (2016) investigated the association between audit fees and audit partner rotation by using empirical evidence from Australia. They developed three null hypotheses. First, higher audit fees have no relationship with audit partner rotation; second, the relationship between audit partner rotation and audit fees does not depend on if that rotation is mandatory or voluntary; third, the relationships between audit partner rotation and audit fees in different segments are the same in audit market. The research was started by selecting sample in companies listed on Australian Securities Exchange from 2007 to 2010. The sample started with 7,968 firm years, and then 65 firm years of financial institutions were excluded because they had different determinants of audit fee and accounting practices. They collected nonfinancial, financial and rotation data, which included industry, foreign subsidiaries and subsidiaries, from annual financial reports, Connect 4 Annual Reports Collection and Morningstar DatAnalysis. Then there were 3,561 firm years were further excluded because of missing data, which resulted 4,342 firm years that consisted of 1,088 from 2007, 1,184 from 2008, 1,080 from 2009 and 990 from 2010; all of them came from 1,260 unique firms. Moreover, in order to test the third hypothesis, they further divided the final sample into groups by using total assets and the number of foreign subsidiaries owned as measurement. The top 40 percent companies in the sample represented the large global market, the bottom 40 percent companies represented the small local market and the remainder represented the mid-level market. The firm years for them are 798, 1,112 and 2432 respectively. Big 4 audited 83 percent of the large global companies, 48 percent of the mid-level companies and 28 percent of the small local companies. Furthermore, in order to

test all three hypotheses, the traditional audit fee model and ordinary least squares regression model were used. As a result, Stewart et al. (2016) found that there was a positive relationship between mandatory audit partner rotation and audit fees specifically for larger global market. In addition, higher audit fees existed in the rotation year, the year followed and the second year after with a lower extent.

## **China**

On October 8, 2003, the policy of mandatory audit partner rotation was issued for listed companies in China by the Ministry of Finance of China (MOF) and the China Securities Regulatory Commission (CSRC), and it became effective on January 1, 2004. In general, it required signing auditors to be changed every five years, and a cooling-off period of two years, which was the same with Australia. However, for the initial public offering entity, signing auditors were required to be changed every two years right after the initial public offering (Firth et al., 2012).

Firth, Rui, and Wu (2012) investigated how the influences of different audit rotations on audit quality was affected by the different institutional conditions in China. They used the likelihood of issuing a modified audit opinion by the auditors as a measurement of audit quality, and their study focused on two research questions. The first one was that whether different types of audit rotations had different levels of impact on audit quality, and the second one was that whether different types of audit rotations would result a higher quality audit in regions which were not well developed. In the process of research design, they first identified different forms of audit rotations, then they analyzed if a company would be more likely to receive a modified audit opinion after the implementation of audit rotation by using the pooled multivariate logistic



regression. In order to investigate the impacts of different audit rotations under different market and legal conditions, they also used the legal environment and market intermediaries index, which was created in 2001 and updated in 2003, 2004, 2007 and 2010 by National Economic Research Institute in China. Furthermore, a sample of 9,761 firm-year observations in China for the 1997-2005 period was selected at the beginning by using the China Stock Market Accounting Research database. Because the first post initial public offering year observations did not include any auditor information from prior year for the annual audit, 828 of them was first excluded from the initial sample. Then they kept excluding 322 firm-year observations from the sample because of the failure in identifying the status of audit partner rotation. They lastly deleted 51 firm-year observations of financial industry, which resulted total 8,560 firm-year observations in the final sample. As a result, Firth et al. (2012) found that the likelihood of issuing a modified audit opinion by an auditor to the companies, which were located in the regions that were less developed, was higher under the implementation of mandatory audit partner rotation.

Bandyopadhyay, Chen, and Yu (2014) investigated how the policy of mandatory audit partner rotation issued in China influenced the audit quality there. They developed three non-directional hypotheses. First, the implementation of mandatory audit partner rotation did not had positive impact on the average audit quality in different provinces of China; second, the levels of positive impact of mandatory audit partner rotation were the same between different provinces that had different levels of audit market concentration; third, the levels of positive impact of mandatory audit partner rotation were the same between different provinces that had different levels of both the legal development and audit market concentration. They selected their sample of financial and audit data by using the database which was created by China Center for Economic Research in Beijing University and Sinofin Technology Limited Company. They

started with an initial sample that consisted of 13,287 firm–year observations from 2004 to 2011, and then finalized it to a sample of 887 firm–year observations, which consisted of 273 for 2003, 273 for 2004, 197 for 2006, and 144 for 2007. Moreover, they used the modified Jones model to measure discretionary (abnormal) accruals, which is one of the earnings quality measures, and used it as the measurement of audit quality. As a result, Bandyopadhyay et al. (2014) found that there was an improvement in audit quality for the publicly listed companies in China in the first three years right after the implementation of mandatory audit partner rotation. More importantly, the study showed that the positive impact was most significant in the provinces of China that had a low level of both legal development and audit market concentration, which means the policy of mandatory audit partner rotation did not bring improvement to the audit quality in the provinces where the legal conditions were well developed, and the audit market was basically dominated by only several large audit companies.

Lennox, Wu, and Zhang (2014) examined the influence of mandatory audit partner rotation on audit quality in China. They developed two hypotheses. First, there were more audit adjustments in the last year of the audit tenure right before the implementation of mandatory audit partner rotation than in other years; second, there were more audit adjustments in the first year of the audit tenure right after the implementation of mandatory audit partner rotation than in other years. They then tested both hypotheses by using a logistic model for audit adjustments. Moreover, they started with an initial sample of 8,087 company-year observations from 2006 to 2010 by using the Inspection Bureau’s audit adjustments database. They first excluded 651 company-year observations from the initial sample, then excluded 338 company-year observations because of the missing data of one or more variables. They also excluded 621 company-year observations which the partner change happened at the same time with the audit

firm change, because the interdependency between those two needed to be addressed. Lastly, they excluded 136 company-year observations where the financial statements were audited by two audit companies, which resulted 6,341 company-year observations in the final sample. Furthermore, descriptive statistics were used for audit adjustments and mandatory audit partner rotation, and univariate tests were used for both hypotheses. As a result, Lennox et al. (2014) found that there was an improvement in audit quality in the years immediately surrounding the implantation of mandatory audit partner rotation. More specifically, there were more audit adjustments in the last and first year of the audit tenure right before and after the implementation of mandatory audit partner rotation respectively.

### **United States**

The American Institute of Certified Public Accountants (AICPA) in the United States established the regulation of mandatory audit partner rotation since the 1970s, and it required audit partners to be rotated every seven years with a cooling-off period of two years. However, the Sarbanes–Oxley Act of 2002 changed the regulation by making it more stringent. The revised regulation required audit partners to be rotated every five years with a cooling-off period of five years, and it became effective on May 6, 2003. In 2008, the Securities and Exchange Commission (SEC) in the United States required the Government Accounting Office (GAO) to investigate if mandatory audit rotation had created significant influence, and the founding indicated that there was no significant positive influence of mandatory audit rotation. In August 2011, the Concept Release on Auditor Independence and Audit Firm Rotation, which suggested mandatory audit firm rotation for the firms in the United States, was issued by the Public Company Accounting Oversight Board (PCAOB). In July 2013, a bill, which amended the Sarbanes–Oxley Act of

2002 to prevent public companies in the United States from being required to rotate their audit firms by the PCAOB, was passed by the U.S. House of Representatives (Litt et al., 2014).

Litt, Sharma, Simpson, and Tanyi (2014) examined how mandatory audit partner rotation influenced the quality on financial reporting in the United States. They developed a null hypothesis which stated that there was no influence of the implementation of mandatory audit partner rotation on the quality of financial reporting. In designing the research, because it is very difficult to obtain information of the commencement and termination for audit engagements, they imposed a condition for selecting their sample. This condition required the companies that changed audit firms had already hired them continually for seven years, which ensured there would be information for both the new incoming auditors and one partner rotation. They also made an assumption that audit partners would stay in the same audit engagement before rotation for five years. Moreover, they conducted a survey to investigate three problems. First, if the SOX 203 was followed by accounting companies; second, if audit partners would be changed before the implementation of mandatory audit partner rotation; third, what reasons of being rotated before the implementation of mandatory audit partner rotation would be. This survey was mailed to 44 public accounting companies, and its showed a result that the regulation of mandatory audit partner rotation was followed by those firms, and the early rotation usually did not exist. Furthermore, they also selected a sample, which only included companies that continually hired the same audit firm for seven years, from all companies that changed audit firms in the period of 2000-2004. As a result, Litt et al. (2014) found that the quality on financial reporting was lower after the rotation of audit partners. Specifically, they found lower quality on financial reporting in the first two years of audit tenure than the last two years with the departing partner. They also found that lower quality on financial reporting was more likely to exist in the engagements with

large clients. What is more, there were challenges in the engagements for Big Four firms in the first year of audit tenure, and they were likely to keep existing for three years in the engagements for firms which were not Big Four. There were also larger challenges existed in the audit companies which were small or at city level.

Sharma, Tanyi, and Litt (2017) investigated how the implementation of mandatory audit partner rotation influenced audit timeliness and audit fees. They developed two hypotheses. First, the implementation of mandatory audit partner rotation did not have any influence on audit fees; second, the implementation of mandatory audit partner rotation did not have any influence on the lag of audit report. When designing their research, they chose to employ an approach which was similar to the one used by Litt et al. (2014). They identified all the companies which changed their audit firms after 2000 and then continually hired the same audit firm during the whole sample period. In order to make comparison between the influences of the continuous implementation of mandatory audit partner rotations, they identified the companies that kept hiring the same audit firm for 11 years, which means there would be two audit partner rotations that were completed. They focused on the period of 2000-2014 to select their sample, which included companies that changed their audit firms in 2000, 2001, 2002, 2003 and 2004, and did not make another change for 11 years. As a result, Sharma et al. (2017) found evidences which indicated that the regulation of mandatory audit partner rotation led to both longer lags of audit report and higher audit fees in the period right after its implementation. Moreover, these influences not only were suggested to be more significant for non-industry specialists, larger companies, and auditors in firms which are not Big Four, but also intended to exist in the continuous implementation of mandatory audit partner rotation.

**Italy**

The first policy of mandatory audit firm rotation in Italy was introduced in 1975, and there have been five important modifications were made to the policy. In the period of 1975-1997, the regulation required audit firms to be rotated every three years, and there were two additional renewable three year terms are allowable; the cooling-off period was five years. In the period of 1998-2004, the cooling-off period became not explicit, but was usually understood as a three-year term. In 2005, the regulation changed to require an audit firm rotation every six years, there was only one additional renewable six-year term; the cooling-off period was three years. Moreover, the audit partner was also required to be changed every six years, and the cooling-off period was also three years. In the period of 2006-2009, the regulation changed to require audit firms to be rotated every nine years, and there was no renewable term. From 2010 to present, the regulation changed to require the audit partner to be rotated every seven years (Corbella et al., 2015).

Cameran, Francis, Marra, and Pettinicchio (2015) investigated the possible influences of mandatory audit rotation on audit quality, working hours for engagement, audit fees and the behavior of the incoming and departing partners by using Italian evidence. The study focused on three questions. First, whether mandatory audit rotation lowered audit quality because there was no incentive of being reappointed for departing partners; second, whether there were higher audit fees and working hours for engagement that caused by mandatory audit rotation for incoming partners; third, whether a lower quality audit existed right after the implementation of mandatory audit rotation because of learning curve effects for incoming partners, or there was actually an improvement on audit quality. Specifically, the study included the use of private data for working hours and audit fees which were given by the Big Four firms in Italy. They investigated

whether the audit fees and working hours for engagement in the first and last year of audit tenure were different from those in other years, and they tested the quality of timely loss recognition and abnormal accruals, which are audited earnings, to assess whether audit quality was changed by mandatory audit rotation. Moreover, they developed a sample of 667 firm-year observations by selecting in 204 companies that were publicly listed and audited by the Big Four firms from 2006 to 2009. The sample included 37 percent of manufacturing industry, 13 percent of technical, professional and scientific services industry, 10 percent of communications and information industry, and the rest of 40 percent were allocated in other 12 industries. There were 36 out of 52 auditor changes were mandatory audit rotations; specifically, the changes from PwC to Deloitte accounted for 22 percent and the changes from Deloitte to E&Y accounted for 14 percent, which were the largest changes. Furthermore, they calculated estimations in model by using three different dependent variables, which included abnormal working capital accruals, total working hours for engagement, and audit fees. In order to control the omitted variable bias and temporal variation, firm fixed effects and year fixed effects were used in estimating all models. As a result, Cameran et al. (2015) found that even though audit quality was not affected by departing partners, audit fees were in fact affected. The audit fees in the final year of audit tenure were higher than those charged in other years by 7 percent. However, the audit fees charged by the new incoming partners in the first year of audit tenure were 16 percent lower than usual even though the working hours for engagement were in fact 17 percent higher at that time, and this discount did not exist in the following years, which led to an increase in audit fees. Moreover, Cameran et al. (2015) also found that there was lower quality audit existed in the first three years right after the implementation of mandatory audit rotation.

Corbella, Florio, Gotti, and Mastrolia (2015) investigated how the implementation of mandatory audit firm rotation created benefits and costs to audit quality, and its relationship with audit fees by using evidence from public companies in Italy. They developed two hypotheses in the null form. First, the implementation of mandatory audit firm rotation did not have any influence on audit quality; second, the implementation of mandatory audit firm rotation did not have any influence on the changes of audit fees that were charged by audit firms. In order to test these two hypotheses, they chose to select a sample from all non-financial companies which were listed on the Milan Stock Exchange for the period of 1998-2011. They first used different companies' websites and the Borsa Italiana website to search for meeting reports of shareholders and corporate annual audit reports to hand collect data of changes in audit partner and audit firm. Then they also used both the annual reports, which had a fiscal year end of or after July 1, 2007, and meeting reports of shareholders to hand collect data of audit fees for the period of 1998-2006. They lastly used the AIDA database, which has financial data of Italian companies that are both unlisted and listed, to collect accounting information from 1997 to 2011, which resulted a final sample that included 1,583 firm-year observations. When designing their research, they not only measured audit quality by using abnormal working capital accruals as a measurement, but also performed a sensitivity test by using abnormal accruals to make sure their result was not going to depend on the selected audit quality measure. Moreover, in order to confirm the results, they found by using the regression models, they also performed different additional analyses. As a result, Corbella et al. (2015) found that the audit fees for the companies which were not a client of Big Four firms did not change, whereas the audit fees for those which were a client of Big Four firms were in fact lower after the implementation of mandatory audit firm rotation. Furthermore, they also found that after measuring audit quality by using two measurements of



earnings management, it was improved in companies which were not a client of Big Four firms after the implementation of mandatory audit firm rotation.

## **Spain**

The regulation of mandatory audit firm rotation was first introduced in Spain in 1988, and it required audit firms to be rotated every nine years. However, this regulation was actually never enforced because Spain abandoned it in 1995, which was only seven years after the regulation was introduced (Ruiz-Barbadillo et al., 2009).

Ruiz-Barbadillo, Gómez-Aguilar, and Carrera (2009) examined the relationship between the regulation of mandatory audit firm rotation and the independence of auditor by using evidence from Spanish experience. They developed two competing hypotheses which considered the influence of mandatory audit firm rotation on the possibility of issuing a going concern opinion by an auditor. First, the likelihood of issuing a going concern opinion by an auditor to a company which was financially distressed was higher under the regulation of mandatory audit firm rotation; second, the likelihood of issuing a going concern opinion by an auditor to a company which was financial distressed was lower under the regulation of mandatory audit firm rotation. They used the database of the Securities and Exchange Commission in Spain, which has audit reports and audited financial data for all the firms that are listed on the Madrid Stock Exchange, to select a sample of companies that were financially distressed from the total 4,817 audited firm-year observations from 1991 to 2000. A final sample of 1,326 firm-year observations was formed, and it included 90 going concern opinions and 33 of them were for the first time. Moreover, the sample covered two periods, which included a period of 1991-1994 that was in the mandatory audit firm rotation, and a period of 1995-2000 that was not in the

mandatory audit firm rotation. This played a role in comparing the behavior of auditors under different circumstances. Furthermore, in assessing the influence of the regulation of mandatory audit firm rotation on the behavior of auditors, they investigated the likelihood of issuing going concern opinions by auditors in both the mandatory rotation period and the period after by initially using a logistic regression model which is a main effects model. What is more, in order to ensure the robustness of their results, they also used different additional analyses. As a result, Ruiz-Barbadillo et al. (2009) found that there was no influence of abandoning the regulation of mandatory audit firm rotation on audit quality.

### **European Commission**

The European Commission considered the regulation of mandatory audit partner rotation was not sufficient for improving the independence of auditors, which made audit quality could not be ensured at an acceptable level. The European Commission argued that the new audit partners from the same audit firm were not likely to make decisions that would be different from those made by the prior partners. However, a new audit partner from a different audit firm would be more likely to make decisions that were different from those made by the prior partners.

Therefore, the European Commission proposed a change from the regulation of mandatory audit partner rotation to the one of mandatory audit firm rotation. In 2014, a new regulation, which required the audit firms of public interest entities to be rotated every 10 years, was established in the European Commission agreement. Moreover, there could be an audit tenure of maximum 24 years for the situation of joint audits, and if a public tender exists, there could be an audit tenure of maximum 20 years (Bandyopadhyay et al., 2014).

**Conclusion**

The debates for both mandatory audit partner and audit firm rotation were initially brought up by the arguments of how a close relationship between the audit partner/firm and the client would create negative influences on auditors' independence, which would not only lower audit quality, but also create audit failure. A lot of different arguments were represented by both proponents and opponents in different countries to prove both the pros and cons for different types of mandatory audit rotation. It has been very difficult to make certain conclusions on both regulations because of the lack of available data in different countries. When a company changes its audit partner or audit firm, there will be additional costs. Therefore, it is necessary for companies to figure out how much benefits that change will bring to them, and more importantly if those benefits exceed the additional costs and in what extent. What is more, future researches should try to use other measurements in measuring audit quality, and to investigate whether those different measurements will create different types of influence on audit quality.

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