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Auditor Tenure and Rotation: The Auditors, Are They A-Changin'?

"Any change, even a change for the better, is always accompanied by drawbacks and discomforts". Arnold Bennett (1867-1931)

For many years now, accounting regulators have had concerns about the possible lack of independence between auditors and their clients arising from a longstanding professional relationship. Concerns about auditor independence were responsible in part for the passage of the Sarbanes Oxley Act of 2002 and the formation of the PCAOB. The concern stems from a widely-held belief that the risk of audit failure increases when an auditor and client remain together for many years. US Congressman Shelby is typical of this view: "How can an auditing firm remain independent….when it has established long term personal and professional relationships with a company by auditing the same company for many years, some 10, 20, 30 years?" The issue is that auditors might get too close to their clients and can lose professional skepticism and objectivity when the relationship goes on too long.

Some have suggested mandatory audit firm rotation as a possible fix to the so-called independence "problem". More than 30 years ago, the Metcalf report recommended mandatory rotation as a way to promote a more independent auditor-client relationship thereby increasing audit quality and investor confidence in the financial statements. In the wake of the Enron-era scandals, the Comptroller General was directed by the Sarbanes-Oxley Act to study the pros and cons of mandatory rotation. On the other hand, short term auditor-client relationships may also carry a high risk of audit failure due to an auditor's lack of familiarity with a client and its operations. The AICPA argues that new auditor-client relationships are inherently more risky, citing a study done by the SEC Practice Section which found that audit failures are 3 times more likely when the auditor is new to the client. Although the Sarbanes Oxley Act requires audit partner rotation the question remains: What is the relation between audit *firm* tenure

and audit quality? A steady stream of research has shed light on this issue by focusing on the association of audit firm tenure and:

- Financial reporting quality
- The incidence of fraudulent financial statements
- The likelihood of auditors issuing going concern opinions for financially distressed clients

Auditor tenure and financial reporting quality

Research has looked at variations in accounting accruals and earnings quality as a proxy for the quality of a company's financial reporting. In general, researchers have found that extreme (abnormal) levels of accruals are associated with reduced financial reporting quality. In terms of audit firm tenure, the question is whether extreme levels of accruals are associated with long term relationships. In general, studies of publicly traded US companies have shown that accruals are less extreme when an audit firm has been associated with a specific client for a long time. That is, as auditor tenure increases, abnormal accruals are less common suggesting that financial reporting quality is *greater* in long term relationships.

Auditor tenure and fraud

The Sarbanes-Oxley Act of 2002 was enacted to improve the "accuracy and reliability of corporate disclosures". Of primary concern to regulators was the possibility that auditors might be less skeptical about conditions associated with possible management fraud if they have associated with a client for too long. Fraud is the deliberate misrepresentation of the financial books and records of an entity. Research in 2004 used a sample of companies charged by the SEC with fraudulent financial reporting. The results showed that undetected fraud is more likely in the early years of the auditor-client relationship. There was no evidence to support the notion that fraudulent financial reporting is more likely in long term audits.

Auditor tenure and going concern opinions

Another possible effect of getting too close to a client is that an auditor may be less willing to issue a going concern opinion when faced with indications of financial distress at a client. Research has shown that most bankrupt companies receive an unqualified opinion on their last set of financial statements prior to filing for bankruptcy. Financial statement users and regulators often view this as a failure of the auditing profession. Researchers have collected samples of bankrupt companies to investigate whether clean opinions are more prevalent in long or short term audits. Once again, the overwhelming conclusion in the literature is that short [not long] term audits are more fraught with problems. Generally speaking, the audit opinions issued to soon-to-be-bankrupt companies are less likely to be modified when audit tenure is short rather than long.

Mandatory Firm Rotation and Audit Quality

The overwhelming conclusion seems to be that long term audits are at least no worse than short term audits, and may reflect better audit quality due the auditor's deeper understanding of the client. Despite this, regulators still appear interested in the concept of mandatory auditor rotation. Under a mandatory audit firm rotation regime, the length of the auditor-client relationship would be capped at 7 or 8 years at which point a new audit firm would be hired. The question is whether there is any evidence that mandatory rotation would help increase audit quality and reduce audit failures?

An important caveat to the research mentioned above is that all the studies have examined the relation between audit quality and auditor tenure in a regulatory regime where changing auditors is a voluntary action. As a result, the duration of an auditor's tenure reflects the joint decision of the client and the auditor. It is not at all certain that previous results would extend to a regulatory regime where rotation was mandatory. In fact, an argument might be made that an auditor nearing the end of a six or seven year contract might pay less attention to the client that will move to another auditor in the future. On the other hand, evidence shows that firms that voluntarily change auditors tend to be in worse financial condition, more often involved in fraud, and more likely to hire auditors that have less expertise.

Is it possible that long term audits appear better because companies who have recently switched auditors are poor performers?

One way to investigate this possibility is to consider research that is aimed more towards audit firm rotation rather than audit firm switching. One research study examined auditor changes that occurred as a result of the demise of Arthur Andersen. Similar to a mandatory rotation regime, Andersen clients were forced into new auditor-client relationships. However, unlike a mandatory regime, the change was a one-time switch which had no pre-defined time horizon. The results show that earnings quality improved after clients were forced to hire a new auditor, although only for the smaller firms in the sample. Another research study examined the Florida government audit environment in which there exists both rotation and non-rotation regimes and found that government entities that periodically rotate auditors issue higher quality reports.

Audit Partner Rotation

Another way to address the usefulness of rotation is to investigate the effect of audit *partner* rotation on audit quality. Section 203 of the Sarbanes Oxley Act requires that the lead audit partner rotate off the audit every five years. In addition the lead audit partner must complete a five year "time out" period before returning to the engagement in a leadership role. The question is whether there is evidence to suggest that partner rotation increases audit quality. A study using 1995 Australian data examined this issue *before* partner rotation became mandatory and before any of the firms in the sample had adopted partner rotation as firm policy. The results were mixed. For long partner tenure audits, the issuance of a going concern opinion was less likely and there was evidence of possible earnings manipulation. On the other hand, there was no evidence of an increase in abnormal accruals for long partner tenure audits.

Conclusion

In summary, while the evidence on short vs. long relationships seems to favor long relationships, the evidence on rotation is mixed. The GAO's study on mandatory auditor rotation noted that "the potential benefits of mandatory audit firm rotation are harder to predict and quantify." Their conclusion was to give the Sarbanes Oxley act "several years" experience so that the "full effects of the act's requirements can be assessed." Given the vested interests of various stakeholders in the audit relationship, the debate on mandatory rotation isn't likely to end anytime soon.

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