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Studies question need for auditor rotation

BY MICHAEL COHN

A pair of academic studies casts doubt on the value of mandatory rotation of auditing firms and lead engagement partners.

The Public Company Accounting Oversight Board has come out firmly against proposals for mandatory audit firm rotation in the U.S., especially after the House of Representatives approved a bill in 2013 that would actually ban mandatory firm rotation. However, the requirement for a lead engagement partner not to serve for more than five years overseeing audits of the same corporate client remains in place from the Sarbanes-Oxley Act of 2002. In the European Union, there's a requirement for mandatory retendering every 10 years in which companies have to invite bids from other audit firms after they've been using a firm for a decade.

However, there have been calls for reforms in the audit market, which remains dominated by the Big Four firms, despite a string of international accounting scandals in recent years. Both the E.U. and the U.K. are planning further reforms, mainly involving separating the audit and consulting practice.

While the calls for mandatory audit firm rotation seem to have quieted in recent years, the two academic studies question the need even for engagement partner rotation. The studies, in the American Accounting Association journals *Accounting Review* and *Auditing: A Journal of Practice and Theory*, look at the two reasons most often cited for mandatory auditor rotation: that personal ties developed over time between auditors and clients can compromise the accountants' professional independence and, thus, the quality of financial reporting, and that mandating rotation brings a fresh look to audits and improves the quality of reporting. Both studies found no significant fall-off in reporting quality over the course of partners' five-year tenures, as limited by SOX, and little or no evidence that the fresh looks mandated by SOX make for improved audits. One of the studies, in the *AJPT*, found evidence of a decline in audit quality when a new engagement partner takes the helm, perhaps due to a loss in familiarity and knowledge about the client.

"I think this study has implications both for current partner-rotation requirements and for potential audit-firm rotations," said Robert L. Whited of North Carolina State University, who co-authored the *AJPT* paper, in a statement. "Some have argued in

favor of rotation that fresh eyes of a new audit partner help improve audit quality, and a similar argument is made by those favoring mandatory firm rotation. However, in our sample, we find no evidence of an improvement in the first year or two following rotation.”

His study, which draws on publicly available data, was co-authored by Huan Kuang and Matthew G. Sherwood of the University of Massachusetts Amherst and Huimin Li of the University of New Hampshire.

The *Accounting Review* study instead draws on proprietary data made available to the researchers from the PCAOB. A joint effort of Brandon Gipper of Stanford University, Luzi Hail of the University of Pennsylvania, and Christian Leuz of the University of Chicago, their study represents the first partner-tenure and mandatory-rotation analysis of a large cross-section of publicly traded U.S. companies, consisting of 3,300 corporate clients of the six largest audit firms, covering 2,385 mandatory engagement-partner rotations over the seven-year period from 2008

From the PCAOB data sample, the professors focused especially on the clients of BDO USA, Deloitte & Touche, Ernst & Young, Grant Thornton, KPMG and PricewaterhouseCoopers. The corporate clients in the sample make up approximately 46 percent of SEC registrants in the U.S. and around 85 percent of aggregate market capitalization.

On the issue of audit quality, the researchers found that, on average, quality over the five-year mandatory rotation cycle was unrelated to the length of the partners’ tenure with clients, except for announcements of restatements, which were more frequent in the first two years after rotation. This increase in announcements of prior misstatements suggests a benefit of fresh looks, but other important indicators of audit quality don’t. For instance, financial misstatements were found to be no less likely to occur during those two years, and accrual levels did not decline, accruals being non-cash accounting items that are usually subjective (such as estimates of inventory value or of bad debts) and are thus considered especially subject to management manipulation.

For the average Big Six client engagement, mandatory rotation appeared to be short enough, or the U.S. audit environment robust enough, to prevent auditor complacency, according to the *Accounting Review* study. The researchers said they found only limited evidence of benefits from taking a fresh look at a company from new auditors.

“Our findings also suggest a likely reason for this apparent lack of fresh-look benefits — namely, that audit firms anticipate and invest resources to reduce potential disruption arising from mandatory partner rotations,” Gipper said in a statement. “For example, audit firms have incoming partners shadow outgoing partners before the transition. Another example, audit firms put in more effort for high-risk and complex clients.”

The *AJPT* study appears in the quarterly's current August/October issue, while the *Accounting Review* study is scheduled for the March 2021 issue.



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