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TAX AND ACCOUNTING

AUGUST 13, 2018

Study Finds Link Between Audit Firm Profits and Client Tenure

Audit fees for Big Four firms increase “noticeably” over the firm’s tenure, according to a paper from two accounting professors at Baruch College in New York.

The academics also found that the accounting firm’s costs to service clients declines as tenure lengthened, and the decline is larger for the Big Four than it is for smaller accounting firms.

“Big Four engagements become more profitable or earn quasi-rents over time, which may explain why Big Four audit firms are so opposed to firm- but not partner-rotation,” said the study by Alope Ghosh and Subprasiri Siriviriyakul. [Section 203](#) of the [Sarbanes-Oxley Act of 2002](#) requires rotation of the lead partner every five years. The study was published in the June 2018 edition of the [American Accounting Association’s Accounting Horizons](#).

“The large jump in fees, especially for the longer tenure years, raises concerns about an economic bonding between audit firms and their clients,” the study said. “Our findings suggest a need to better monitor auditor independence and audit judgments when tenure is long.”

The study comes about seven years after the PCAOB in 2011 floated the idea of mandatory audit firm rotation in [Concept Release No. 2011-006](#), Auditor Independence and Audit Firm Rotation. Some investor protection advocates and regulators believe that long auditor-client relationships can chip away at an auditor’s skepticism and independence leading to an erosion in audit quality. Term limits on client relationships, they believe, would counter the tendency by auditors to become too familiar with long-term clients and aid efforts to shore up auditor objectivity and independence.

However, the PCAOB abandoned its work on mandatory rotation after companies and auditors lobbied against it, saying it would drive up costs and disrupt the financial reporting process without improving audit quality. Moreover, firms argued that it takes time to become well-versed in the complex financials and operations of a new public company client. Ghosh and Siriviriyakul’s study said Big Four firms spent \$10 million on political campaigns and another \$12.6 million on federal lobbying efforts opposing any regulation related to auditor independence while the PCAOB was considering the rotation rule. The House of Representatives passed a bill to block the PCAOB from issuing a rule to mandate audit firm rotation in 2013, but the measure never made it past the Senate.

To do the study, the researchers looked at audit firm tenure and fees of public companies from 2000 to 2013.

During the 14-year period, Big Four audit fees increased on average by 13 percent between the first year and the second and about 22 percent between the first year and the third. By year 12, the fees were 28 percent more than the original fee, and they were 32 percent more by year 14. In contrast, the fees for non-Big Four firms decreased slightly up to 10 years, and then the change in the annual fee became statistically insignificant after 10 years.

The fee increases for the Big Four were not a result of more workload as the study controlled for other factors. In fact, the study found that the audit firm's workload declined as auditor tenure increased.

To measure audit cost, the researchers used a measurement they termed the "audit report lag" that measured the number of days between the end of a client's fiscal year and the date of the auditor's report in the regulatory filing. The study found that the audit report lag for Big Four Firms declined by about 2 percent in the second year of an relationship with a client. The decline was about 9 percent to 10 percent relative to the initial year of the client engagement when the tenure is between four and five years. The decline is about 16 percent relative to the first year when the tenure is nine years. When the tenure is 12 years or longer, the decline is 12 percent.

The Center for Audit Quality, an AICPA affiliate that represents public company auditors, including the Big Four, did not respond to a request for comment.

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