

THE EFFECTS OF AUDIT FIRM ROTATION ON EARNINGS QUALITY

EUGEN NICOLĂESCU

eugen.nicolaescu@cdep.ro

Dimitrie Cantemir Christian University

ABSTRACT. Over the past decade, there has been increasing evidence describing abnormal accruals and earnings response coefficients as proxies for audit quality, the effect that the length of the auditor-client tenure has had on audit quality, audit procurement mechanisms such as rotation of the audit firm or the audit partner, and the pros and cons of long-term auditor-client relationships. The objective of this paper is to emphasize the quality of audited earnings around the rotation event, the cost of mandatory auditor rotation, earnings management and auditor rotation in the public sector, and effects of audit firm rotation on financial accounting and audit quality.

JEL Codes: H83; M4

Keywords: mandatory audit firm rotation; earnings management

1. Introduction

In this paper I am particularly interested in exploring the effect on earnings quality of rotating the audit firm, the possibility of mandatory firm rotation, the effect of external rotation on the quality of financial accounting and audit, and the impact of auditor rotation on the quality of earnings. The results of the current study converge with prior research on the potentially far-reaching effects of adopting a policy of mandatory firm rotation, the effects of tenure on auditor independence, the relation between audit firm tenure and measures of audit quality, and the possible triggers of investors' reactions to the prospect of mandatory audit firm rotation. My analysis complements the growing literature on the effects of long audit tenures on independence, the potential benefits and costs of imposing mandatory audit firm rotation, and the effect of mandatory audit-partner rotation on audit quality.

2. The Effect of Mandatory Audit-Partner Rotation on Audit Quality

Firms with an industry expert as an auditor experience a significantly more negative market reaction than firms without an expert auditor. The market

reaction is significantly more negative for firms with long auditor tenure (Popescu, 2013c) compared to firms with shorter auditor tenure. Companies receiving a high quality audit from their current auditors (Nicolăescu, 2012) experienced a more negative market reaction compared to companies receiving a lower quality audit. Investors respond negatively to the discussion of mandatory rotation as they value the expertise of their current auditor, view rotation as especially undesirable for companies utilizing an industry expert or Big 4 auditor, are more opposed to forced rotation if firms are receiving high quality audits from their current auditor, and have reservations about the possible implementation of rotation for certain firms. Mandatory audit firm rotation may provide benefits to firms and investors by potentially improving audit quality. As size increases, firms might react more positively to the prospect of forced rotation. Investors on average oppose the prospect of mandatory firm rotation (this opposition is greater for investors in firms with longer audit firm tenure and investors in firms with higher audit quality). (Carcello and Reid, 2013)

The external auditor's role is crucial in the corporate governance scheme. Long auditor-client relationships may cause auditor complacency about management decisions (Popescu, 2013e) regarding the firm's financial statements. The mandatory rotation of external auditors may improve independence. In high litigation risk countries, auditors could be less willing to impair independence compared with the situation in low litigation risk countries. The opinion of the audit report depends on the characteristics of the incumbent auditor. NonBig4 auditors tend to audit relatively small companies, whereas large firms are more able to avoid losses than small firms. Firms with unqualified reports show significantly longer tenures compared with firms with qualified reports. Losses and lower levels of solvency are positively associated with a higher frequency of audit qualifications. The length of the auditor-client relationship does not significantly affect the opinion of the audit report (long audit tenures do not seem to compromise independence). Auditor rotation rules may provide some benefits in terms of auditor independence, involving an increase in learning costs (Nica, 2013) for the audit sector associated to new clients. Establishing a mandatory rotation rule for the audit firm would not contribute to enhance independence, while increasing costs for the audit sector. (García Blandón and Argilés Bosch, 2013) External auditor rotation may be a way to enhance audit quality due to prevention of the auditor's depending relationship with the management. Traditional agency conflicts are characteristic in large management (Nica, 2012) operated corporations. Even a statutory long-term rotation cycle cannot prevent essential agency conflicts. Audit market concentration is an important disadvantage of compulsory rotation. The Big Four companies have the highest experience value in auditing capital market oriented enterprises. The

impacts under external rotation are stronger than for internal auditor rotation. The majority of empirical assessments disapprove of audit firm rotation. An enhancement of auditor independence will not necessarily be achieved by implementing external rotation. (Velte, 2012)

3. The Potential Benefits and Costs of Imposing Mandatory Audit Firm Rotation

Mandatory rotation is potentially of greater value in a country with a thin audit market (Italy). Italian audit regulation prohibits the auditor from providing many types of non-audit services. Mandatory rotation may affect the behavior of the outgoing and incoming auditors with respect of audit fees, engagement hours, and audit quality. Audit fees increase with each year of auditor tenure following the initial engagement year. Earnings quality improves with tenure, whereas the first three years of earnings following a mandatory rotation are significantly lower in quality compared to those engagements with longer auditor tenure. In the Italian mandatory rotation setting, there is less uncertainty about the length of the auditor's tenure compared to settings where auditor changes are voluntary and could occur at any point in time. Mandatory audit firm rotation leads to abnormally higher fees by the outgoing auditor. The quality of audited earnings is adversely affected by mandatory rotation. The one-year snap shot around the rotation year does not give an accurate picture of the effect of rotation on earnings quality. Auditors can extract private benefits (Nicolăescu, 2013b) from mandatory rotation in the years subsequent to rotation through abnormally higher fees and reduced partner effort. The negative effects of mandatory rotation observed in Italy might be greater in countries with larger audit markets and larger clients. Mandatory rotation in Italy is costly, and has a short-term adverse effect on earnings quality. (Cameran et al., 2014)

Audit quality increases with audit firm tenure, when proxied by the propensity to issue a going concern opinion (mandatory audit firm rotation will not improve audit quality). Firm rotation may help to prevent large-scale corporate collapses. Mandating firm rotation would lead to a loss of client knowledge when the auditor is forced to resign. The largest accounting firms may increase their market share under mandatory rotation, leading to a less competitive environment. Audit firms by virtue of their own internal quality procedures (Nicolăescu, 2013a) have a tendency to shed risky clients. Firms with higher levels of discretionary accruals are able to manage earnings which lead to lower audit quality. Audit quality as measured by the propensity to issue a going concern opinion and the level of discretionary accruals is impacted by a change in auditor. Firms audited by an industry leader have higher levels of discretionary accruals but not at any meaningful level of

significance. There are minimal benefits of imposing mandatory audit firm rotation onto Australian firms. Given the costs involved in switching auditor, mandatory audit firm rotation would not be beneficial to the market. (Jackson, Moldrich, and Roebuck, 2008)

4. The Relationship between Auditor Rotation and Earnings Quality

Audit partner rotation is a costly practice for auditing firms. Longer audit firm tenure is associated with higher quality financial reporting. Changes resulting from audit *partner* rotation are more limited in scope than changes from audit *firm* rotation. Partner rotation cannot solve independence problems arising from audit firm culture. Sharper proxies for audit quality will capitalize on the institutional features of the audit environment. (Bamber and Bamber, 2009) The rotation has impacted the quality of accounting information (Nicolăescu, 2013d) disclosed to the market by Brazilian public companies: rotation of the auditing firm does not have a significant effect on the propensity of listed Brazilian companies to manage earnings. (Lopo Martinez and Mendes Ribeiro Reis, 2010) Rotation of auditors may be a means of enhancing auditor independence (Nicolăescu, 2013c) and building shareholder confidence in the integrity of the firm's financial statements. There is a greater perception of auditor independence and likelihood that errors discovered by the auditors will be reported when a company follows a rotation policy. Rotating appears to enhance perceptions of auditor independence. (Daniels and Booker, 2011)

Earnings quality encompasses audit quality and is influenced by the incentives and actions of managers (Popescu, 2013a) to manipulate earnings. Compulsory audit tendering (CAT) introduces a context of voluntary audit firm rotation as local councils have the opportunity to rotate audit firms every six years. Agency and accountability relationships exist in the public sector context of local government. Councils have an incentive to manipulate earnings to attest to superior resource management and accountability to stakeholders (Popescu, 2013d), and experience pressure from all funding sources to deliver high quality and value-adding services at a reasonable cost. Auditor rotation develops a sound perception of auditor independence, which affects financial report users' decision making. Earnings management has been proxied by discretionary accruals, measured as the residual from models that relate total accruals to underlying economic activity (Popescu, 2013b) and from models that relate earnings to cash flows. Auditor rotation overcomes the familiarity threat to independence as a new audit firm tends to conduct a more rigorous audit process, whereas auditor rotation may cause information asymmetry for the new auditors due to the steep learning curve and their lack of specific expertise. For the independent variables, the revenue, total profits, return on assets and operating cash flow figures indicate that retainers are larger than

rotators (retainers pay higher audit fees, and rotators are more highly leveraged). Both rotators and retainers realize improvements in earnings quality over the period of the audit firm's tenure. For councils that retain their auditors, the level of earnings management is higher in the first year after the tender. For councils that rotate to a new audit firm, the level of discretionary accruals is not significantly different in the first year after the tender. (Adrian, Wright, and Butcher, 2012)

5. Conclusions

The current study has extended past research by elucidating the effect of auditor rotation on audit fees and audit effort, the potential negative consequences of mandatory rotation, the impact of audit firm rotation on measures of earnings management, and the effect of voluntary audit firm (non)rotation. The overall results provide strong evidence for the effect of mandatory rotation on audit engagement hours and audit fees, the impact of rotation versus no rotation on perceptions of auditor independence and audit quality, the benefits and drawbacks of audit firm rotation, and the audit quality's effects on audit tenure. As a result of these earlier research findings, this study sought to determine the effect of rotation on engagement hours, the rotation opportunity provided by compulsory audit tendering, the application of external auditor rotation, and the potential effects of imposing mandatory rotation. These findings highlight the importance of examining the effect of mandatory rotation on earnings quality, the relationship between auditor rotation and earnings quality, and the negative market reaction to the possibility of mandatory auditor rotation.

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