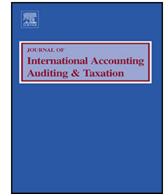
Journal of International Accounting, Auditing and Taxation 25 (2015) 46–66

Contents lists available at ScienceDirect

Journal of International Accounting, Auditing and Taxation



Audit firm rotation, audit fees and audit quality: The experience of Italian public companies

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ARTICLE INFO

Article history:
Available online 22 October 2015

Keywords:
Mandatory audit firm rotation
Audit quality
Audit fees
Audit partner rotation
Audit market regulation

ABSTRACT

This paper examines some of the costs and benefits associated with audit firm rotation using data from Italy, where mandatory audit firm rotation has been in place since 1975. Previous studies in this area did not find consistent evidence of an association between audit quality and voluntary or mandatory audit firm rotation. A recent paper, examining Italian public companies audited by a *Big 4* audit firm, uses proprietary data and finds no statistically significant association between audit firm rotation and audit quality. In this study, we hand-collect publicly available data for a larger sample of Italian public companies audited by a *Big 4* and *non-Big 4* audit firm (1583 firm-year observations) over a longer time horizon (1998–2011). We find that audit quality, proxied by two different measures of earnings management, improves following audit firm rotation for companies audited by a *non-Big 4* audit firm. Additionally, we examine whether higher audit fees are associated with audit firm rotation. Our results indicate that following audit firm rotation, the total amount of fees paid to the auditor was lower for companies audited by a *Big 4* and unchanged for companies audited by a *non-Big 4* audit firm. The results of this study should be of interest to European and U.S. legislators who are currently, or have recently, considered implementing mandatory audit firm rotation in order to improve financial reporting quality.

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1. Introduction

Agency theory indicates that the separation of management (agent) from ownership (stakeholder) leads to a moral hazard problem because the agent (management) may pursue his own self-interest at the expense of the principal (stakeholder) (Jensen & Meckling, 1976). The moral hazard problem is amplified by information asymmetry between the two parties: managers, who run the company, know more about the company and its future prospects than do shareholders. One way to reduce the consequences and the costs associated with moral hazard is to hire an external third party – an independent public accounting firm – to audit the books, records, and financial statements of a company, thereby reducing information asymmetry between the company's agents and its principals.

Audit quality is a function of the auditors' education, training, and knowledge of professional standards, as well as their independence and objectivity, their knowledge of the client's business operations and industry, and the audit team's working

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http://dx.doi.org/10.1016/j.intaccaudtax.2015.10.003
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relationship with the client company's management. There are two primary schools of thought regarding long audit firm tenure. One school believes that audit firms with relatively longer tenure have greater knowledge of the company's business and industry, thereby providing a higher quality and more efficient audit (Geiger & Raghunandan, 2002; Johnson, Khurana, & Reynolds, 2002; Myers, Myers, & Omer, 2003; Carcello & Nagy, 2004). The other school believes that audit firms with relatively longer tenure provide an increased likelihood of familiarity (or even friendships) forming between the audit staff members and client staff members, an increased likelihood of a stale audit program, and a decreased likelihood that the auditor will make decisions contrary to the prior year decisions, thereby providing a lower quality and less efficient audit (Defond & Subramanyam, 1998; Arel, Brody, & Pany, 2005; Gates, Lowe, & Reckers, 2007; Dao, Mishra, & Raghunandan, 2008; Daniels & Booker, 2009). Interestingly, this latter school of thought is driven primarily by perceptions not empirical evidence.

In an effort to strengthen auditor independence, many countries have legislated limitations on the auditor–client relationship including: mandatory audit partner rotation, hiring and firing of the audit firm by the audit committee rather than management, internal reviews of audit engagements, and external peer or regulated reviews of audit engagements. Additionally, some countries, including the United States (U.S.) post-Sarbanes–Oxley Act of 2002 (SOX), limit the types of services a public accounting firm can provide to its audit clients[1], and the type of employment an auditor can take with a client company[2].

SOX, Section 203, requires rotation of the partner on an audit engagement of a public company every 5 years, but does not, currently, require audit firm rotation (Bradshaw & Sloan, 2002). In 2003, the General Accounting Office (GAO) released the results of a study on the potential effects of mandatory audit firm rotation. The GAO concluded that "mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional financial costs and the loss of institutional knowledge of the company's previous audit firm of record, as well as the current reforms being implemented." Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation 2003, p.1). The GAO also suggested a "wait and see" attitude until the other reforms put in place by SOX were in effect for several years, thereby leaving open the possibility that audit firm rotation would be considered again in the future (Government Accounting Office (GAO), 2003) Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation 2003).

In August, 2011, the Public Company Accounting Oversight Board (PCAOB) issued a Concept Release (no. 39) on auditor independence, objectivity, and professional skepticism, including consideration of mandatory audit firm rotation. The comment period originally expired in December, 2011, but was extended to April of 2012 in order to solicit more feedback. In total, the PCAOB received 659 comment letters related to this concept release; most letters vehemently opposed mandatory audit firm rotation. During July, 2013, the Financial Services Committee of the U.S. House of Representatives took the decision out of the hands of the PCAOB by overwhelmingly passing a bill amending the Sarbanes–Oxley Act of 2002 to prohibit the PCAOB from requiring public companies to use specific audit firms or requiring public companies to change audit firms on a rotating basis; the bill also directs the GAO to revisit their 2003 study mentioned above. The bill next will be taken up by the Senate Committee on Banking, Housing, and Urban Affairs. Interestingly, in April of 2013, the European Parliament's Legal Affairs Committee took related action by approving a draft law that would require public entities to rotate audit firms every 14 years (with a possible extension to 25 years if certain safeguards are in place).

This paper adds to the existing literature regarding mandatory audit firm rotation and also informs both the decision taken by authorities in the U.S. to end discussion of mandatory audit firm rotation and the seemingly opposite decision taken by the authorities in the European Parliament. We examine some of the costs and benefits associated with mandatory audit firm rotation using data from a country, Italy, where mandatory audit firm rotation has been in place since 1975. Italy is one of the very few countries in the world to mandate audit firm rotation and is, therefore, a unique setting to examine this topic. Specifically, we test whether there is a change in audit quality associated with both mandatory and voluntary audit firm rotation. We also test whether there is a change in total audit fees paid to the auditor when there is a mandatory or voluntary audit firm rotation.

A recent study examining Italian public companies audited by a *Big 4* audit firm with private data provided by the *Big 4* audit firms (Cameran, Francis, Marra, & Pettinicchio, 2015) found no statistically significant association between audit firm rotation and audit quality. We first replicate the results of Cameran et al. (2015) using publicly available data and then extend our sample to include Italian public companies audited by a *non-Big 4* audit firm and to examine a longer time period. Extensive empirical research has shown that earnings quality is different for companies audited by one of the *Big 4* audit firms vs. companies audited by *non-Big 4* audit firms. This body of research has examined both U.S. companies (DeAngelo, 1981; Khurana & Raman, 2004) and companies from around the world (Francis & Wang, 2008).

Overall, our results indicate that for companies audited by *non-Big 4* audit firms, audit firm rotation is associated with an increase in audit quality without the added cost of an increase in audit fees. By contrast, for companies audited by *Big 4* audit firms, audit firm rotation is not associated with an increase in audit quality but is associated with a decrease in audit fees; these latter results confirm the findings in previous literature. This study makes several contributions to the literature. First, it replicates and extends a recent study (Cameran et al., 2015) using publicly available data that include

[1] SOX Section 201.
[2] SOX Section 206.

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