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Research Report

Can the academic literature contribute to the debate over mandatory audit firm rotation?

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ABSTRACT

Recently, the Public Company Accounting Oversight Board (PCAOB) issued a concept release soliciting public recommendations to improve auditor independence and audit quality (PCAOB, 2011). The focus of the release is on mandatory audit firm rotation (MAFR) with a request for commentaries addressing the advantages and disadvantages of MAFR. In this paper, we briefly summarize the recent literature on mandatory audit firm rotation and suggest how it can be useful to regulators as they consider the implementation of mandatory rotation. We find that the conclusions reached about the possible effectiveness of MAFR appear to depend on the type of data used (voluntary vs. mandatory auditor changes), suggesting that regulators should exercise care when drawing inferences from past audit firm rotation research.

Introduction

Recently, the Public Company Accounting Oversight Board (PCAOB) issued a concept release soliciting public recommendations to improve auditor independence and audit quality (PCAOB, 2011). The focus of the release is on mandatory audit firm rotation (MAFR) and the PCAOB requests commentaries addressing the advantages and disadvantages of MAFR.[1] In March of 2012, the PCAOB conducted 2 days of hearings on the pros and cons of MAFR. The hearings featured several former regulators who addressed the costs and benefits of MAFR. There was little consensus. While former Federal Reserve chairman Paul Volcker said his experience "does suggest to me the importance of requiring rotation" (Tysiac, 2012), former SEC chairman Breeden seemed less convinced saying that "mandatory rotation would benefit some companies and it would probably harm others" (Chasen, 2012). Charles Bowsher, former U.S. comptroller general, suggested a limited MAFR arrangement that would apply to only the largest 25 or 40 publicly traded companies. Finally, former SEC chairman Harvey Pitt expressed concern that with MAFR, "the cure could turn out to be worse than the disease, depending on the amount of time people would be required to rotate off" (Cohn, 2012). Given the opposing views on MAFR, the purpose of this paper is to provide a critical summary of recent research and suggest how it might be useful to regulators as they consider the implementation of mandatory rotation in the U.S.

In an extensive review of the research examining the causes and consequences of auditor switching, Stefaniak, Robertson, and Houston (2009) note that most studies look at the association of auditor tenure and various measures of audit quality. In general, they find that audit quality is

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[1] This represents the second time in 10 years that regulators at the federal level have formally considered the implementation of MAFR. In 2003, the U.S. General Accounting Office (GAO) concluded that the Securities and Exchange Commission (SEC) and the PCAOB should not consider mandating audit firm rotation until the full effects of the Sarbanes–Oxley Act of 2002 could be assessed. The GAO report also noted that, in the future, the PCAOB will likely need to "...evaluate whether further enhancements or revisions, including mandatory audit firm rotation, may be needed to further protect the interest and to restore investor confidence" (GAO, 2003, p. 5).

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higher when there is a longer auditor–client relationship, a finding that would seem to mitigate against a policy of MAFR (DeFond & Francis, 2005; Stefaniak et al., 2009). The problem with this inference is that most of these studies use data from a regulatory regime in which changing auditors is *voluntary* (as is currently the case in the United States). As a result, it is unclear that these results would extend to a regulatory regime where audit firm rotation is *mandatory*.[2]

In this paper we compare studies that are based on voluntary auditor changes with those that are based on mandatory or quasi-mandatory auditor changes[3] since it appears that the PCAOB is especially interested in studies involving the latter.[4] We find that the conclusions reached about the possible effectiveness of MAFR depend on the type of data used, suggesting that policy makers exercise caution when drawing inferences from academic research.

The remainder of the paper is organized as follows. In the next section, we provide a brief summary of the MAFR debate, and discuss how the academic community has responded to calls for research concerning the potential benefits of MAFR. In Section 'Evidence on mandatory audit firm rotation', we briefly summarize the evidence from the academic research, with a focus on differentiating those academic studies that use voluntary changers data from those that employ mandatory rotators data. Section 'Summary and discussion' concludes with a discussion of the implications that these two subsets of the audit firm rotation research have on the MAFR debate.

The debate and the academic response

The arguments for and against mandatory audit firm rotation are well-documented.[5] Proponents of MAFR believe that long-tenure auditor–client relationships increase the likelihood of audit failures. This belief is based on the assumption that a long-tenure relationship leads to an increased level of familiarity between the two parties that naturally erodes auditor independence and professional skepticism.[6] Hence, proponents believe that audit firms should be required to roll-off engagements after a fixed period of time. Such a policy would prevent the existence of any long-tenure auditor–client relationships which would, they argue, decrease the number of audit failures. Conversely, opponents of MAFR point out that audit firms gain valuable knowledge about their clients over time. As a result, opponents express concern that a mandatory rotation policy would result in a lack of client-specific knowledge, causing short-tenure auditor–client relationships to be more prone to audit failures.

Table 1
Types of auditor–client relationships by mandatory rotation regime.

Mandatory rotation regime?	Short-tenure (e.g., ⩽3 years)	Medium-tenure (e.g., 4–6 years)	Long-tenure (e.g., ⩾7 years)
Yes	Cell 1	Cell 2	Not applicable
No	Cell 3	Cell 4	Cell 5

Table 1 summarizes the various types of auditor–client relationships that would exist with and without a MAFR policy. In particular, the table describes audits in terms of mandatory rotation regime (yes/no) and auditor tenure (short/medium/long). For purposes of this table, we define short-tenure relationships as those between 1 and 3 years, medium between 4 and 6 years, and long as 7 years or longer.[7] Since the U.S. does not have a MAFR requirement, auditor–client relationships in the U.S. can be either short, medium, or long (cells 3, 4 or 5). Conversely, in a regime with mandatory rotation, no long-term auditor–client relationships would exist, leaving only short and medium relationships (cells 1 and 2).

If the United States were to adopt a rotation policy, long-tenure audits (cell 5) would be forced into short-tenure audits (cell 1). Proponents argue that such a shift would result in higher audit quality due to enhanced auditor independence. In contrast, opponents believe that audit quality would decline because the new auditor would lack experience with the client. Put simply, proponents of MAFR argue that short-tenure auditor–client relationships will result in higher quality audits, while opponents of MAFR argue that short-tenure auditor–client relationships will result in lower quality audits.

The goal of research in this area is to provide evidence regarding the potential effect of mandatory rotation on the quality of audits conducted on U.S. companies. Ideally, one would compare measures of audit quality from cell 5 audits with those from cell 1 audits. Because the U.S. does not have a mandatory rotation policy in place, the necessary data from cell 1 audits for U.S. public companies is not available. To circumvent this data issue, most studies substitute cell 3 data for cell 1 data. Generally speaking, these studies analyze the differences in various measures of audit quality between cell 5 and cell 3, and find that the quality of cell 5 audits are, on average, significantly better than the quality of cell 3 audits. Based on that evidence alone, one would conclude that a mandatory rotation policy would have a negative effect on audit quality, resulting in a higher occurrence of audit failures.

This is where the data is issue is important. By replacing cell 1 audits with cell 3 audits, these studies rely on the assumption that the characteristics of companies with auditor relationships that fall into cell 3 are similar to those that would have short-term auditor relationships in

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[2] In fact, the PCAOB points out this limitation of the academic literature on p. 16 of its concept release.

[3] We use the term "quasi-mandatory data" to characterize the data gathered from controlled experiments that are designed to mimic a MAFR environment.

[4] Throughout the manuscript, we refer to new audits created in a MAFR regime as "rotators" and new audits stemming from voluntary switching decisions as "changers".

[5] See Stefaniak et al. (2009) for a review of the advantages and disadvantages of MAFR.

[6] See Previts (1998) for a review of auditor independence, its origins and the potential for auditor conflicts of interest. In addition, Kleinman, Palmon, and Anandarajan (1998) provide an extensive review of studies that investigate auditor independence.

[7] Of course, the specific number of years used by the regulator to classify each relationship could be different from those that we use. Related to this point, the PCAOB asks for input regarding the "appropriate term length" for rotation in its concept release.