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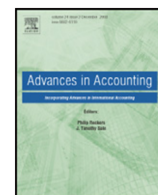

Mandatory audit partner rotation, audit market concentration, and audit quality: Evidence from China☆

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ABSTRACT

This research examines the audit quality consequences of China's mandatory audit partner rotation (MPR) regulation, which became effective in 2004. The rule requires firms to rotate signing audit partners of audit reports every five years. We find that audit quality improves in the three years immediately following a client firm's MPR during the 2004–2011 period for a sample of 273 Chinese publicly listed firms. Specifically, we find that the improvement is most pronounced in those Chinese provinces with both low levels of audit market concentration and low levels of legal development. However, MPR does not improve audit quality in jurisdictions where legal conventions are more developed and/or where audit markets are highly concentrated with a handful of large audit firms dominating the market.

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1. Introduction

In this study we examine the effects of mandatory audit partner rotation (MPR) on audit quality. Specifically, we look at the effects of MPR under varying audit market concentration (AMC) conditions in the Chinese audit market, where, starting in 2004, regulators required client firms to rotate audit partners every five years. We find that MPR improves audit quality in provinces with low levels of AMC but not in provinces with high levels of AMC. Our results suggest that the effectiveness of MPR policy on audit quality depends on the structure of the audit market. Our research contributes to audit literature by relating two long-standing issues, namely, the consequence of MPR on audit quality, and the impact of AMC on audit quality. Both these issues have recently re-entered the public debate in the USA (Public Company Accounting Oversight Board, 2011a) and the European Commission (EU) (2011).

In the post-Enron era, several countries have mandated periodic rotation of the lead audit engagement partner and the concurring reviewing partner in order to improve audit independence and thus audit quality. For example, the Sarbanes–Oxley Act (henceforth SOX, 2002) mandates US audit partners to rotate their audit clients every five years, and the European Union requires audit firms to replace audit partners in charge of their clients that are Public Interest Entities every seven years. Similar MPR requirements are also in vogue in Australia, China, Taiwan, and many other jurisdictions.[3] The consequence of mandatory auditor rotation (at firm or partner level) on audit quality depends on the tradeoff of improvement in audit independence versus loss in client-specific audit experience (Kinney & McDaniel, 1996; Knapp, 1991; Mautz & Sharaf, 1961).[4] On the one hand, a fresh look into the audit engagement by the rotated-in audit partner improves audit independence and thus the quality of the audit. On the other hand, the rotated-in partner does not possess the client-specific expertise of the rotated-out partner, and this lack of experience could reduce audit quality. The final effect of MPR on audit quality is an empirical issue determined by the tradeoff. Empirical evidence on the relation between MPR and audit quality is mixed. Studies based on the Taiwanese audit market indicate either no effect or a negative effect of MPR on audit quality (Chen, Lin, & Lin, 2008; Chi & Huang,

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[3] Other countries adopting MPR include Singapore, Japan, United Kingdom, France, Spain, the Netherlands, and Germany (General Accounting Office 2003, Appendix V; Chi et al., 2009).

[4] These authors use the generic "auditor" term in their papers and do not specify whether their arguments apply to audit firm or audit partner level. These arguments apply equally well to both firm and partner level (Chen et al., 2008). DeAngelo (1981) defines audit quality as the joint probability that an auditor detects a breach of accounting standards and the probability that the auditor reports the breach. MPR will likely decrease the probability of detecting a breach because of lost audit knowledge but increase the probability of reporting the breach.

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2005; Chi, Huang, Liao, & Hong, 2009). In contrast, research based on the Australian audit market (Carey & Simnett, 2006) provides some evidence that MPR tends to enhance audit quality. Experimental evidence (Dopuch, King, & Schwartz, 2001; Tan, 1995) also suggests that MPR improves audit quality. Note that while the identity of audit partners is public information in Taiwan and Australia, and thus the effect of MPR on audit quality can be evaluated directly, this is not the case in many jurisdictions, including the USA.

Recently, the European Commission (EU) (2011) has expressed the view that the practice of MPR does not improve audit independence (and hence audit quality). The argument is that MPR does not remove the familiarity threat that might cloud audit judgment and reduce professional audit skepticism of a new (rotated-in) audit partner, who would not have incentives to take decisions that might cause the audit firm to lose a long-standing client firm. Hence, new (replaced) audit partners "likely feel obliged to live with the decisions and agreements made by the former (rotated-out audit) partner; he/she may have little flexibility to reopen them" (European Commission (EU), 2011, page 17). On the basis of these arguments, European Commission (EU) (2011) proposes mandatory audit firm rotation (MFR) to replace MPR. Consistent with the view of the European Commission (EU) (2011), the US Public Company Accounting Oversight Board (henceforth PCAOB) issued a concept release in August 2011 (PCAOB, 2011a) that also suggests MFR for US firms.

The accounting community, however, has generally opposed the proposal to replace MPR with MFR. For example, a summary of responses to the MFR study by the General Accounting Office (GAO, 2004, Question 73) shows that about two-thirds of the respondents appear to believe that relative to potentially more costly MFR, MPR sufficiently achieves the intended benefits of taking a fresh look at the audit engagement by the rotated-in partner. In their response letter to the PCAOB (PCAOB, 2011b), the International Federation of Accountants (henceforth IFAC) argues that "these changes [MPR] are still relatively new, and have not been in place sufficiently long enough to objectively assess their impact." This IFAC response implies the need for further examination of the consequences of MPR.

In summary, while many in the professional accounting and audit community believe that MPR enhances audit quality, international regulators do not seem to share that view. Moreover, as discussed above, academic research provides mixed evidence on the impact of MPR on audit quality.

Responding to the call of IFAC for further research on the effects of MPR, we examine the relation between MPR and audit quality in the Chinese audit market to provide some insight into this contentious debate. Also, in contrast to extant research, we consider the impact of regional variation in AMC, whose role has recently been highlighted in the foregoing MPR *versus* MFR deliberations. For example, the Center for Audit Quality (henceforth CAQ) argues in its written statement (PCAOB, 2011c) to PCAOB's (2011a) concept release that many small audit firms will find the costs of periodic tendering, documentation and staffing associated with MFR too onerous and will be forced to "abandon their public practice and focus instead on private company audits" (PCAOB, 2011c, page 12). This suggests that abandonment of MPR for MFR could lead to a higher level of concentration of the Big 4 audit firms in many public audit markets that are already considered highly concentrated by policymakers.

For example, European Commission (EU) (2011) has expressed concerns that a potential demise of any of the existing Big 4 audit firms in highly concentrated audit markets might de-stabilize the financial system. There is also concern that "concentration among a few firms enabled the largest accounting firms to exercise greater influence over the audit standard setting process and regulatory requirements." (GAO, 2003) Audit quality could also be compromised through moral hazard issues if large audit firms believe they are "too few to fail" (GAO, 2003). The lack of choice in audit markets dominated by Big 4 audit firms is another concern. Client firms might not want to be audited by the same audit firm that audits its competitors (European Commission (EU), 2011).

Regardless of such comments, which reflect serious policy concerns about the consequences of heightened AMC, recent research often finds a positive relation between AMC and audit quality (Francis, Michas, & Seavey, 2013; Kallapur, Sandaraguruswamy, & Zang, 2010). In our paper we examine whether MPR can improve audit quality in low AMC jurisdictions where extant research tends to report lower audit quality than that in high AMC jurisdictions. It might be noted that, to date, audit research has either examined the relation between audit quality and MPR without controlling for AMC (e.g. Carey & Simnett, 2006; Chi et al., 2009) or the relation between AMC and audit quality without controlling for MPR (Kallapur et al., 2010). The unequal pace of audit market development across Chinese provinces makes it an ideal setting for our analysis. For example, our Chinese MPR sample exhibits a wide range of variation in AMC at the provincial level. During the 2004 to 2011 sample period, the provincial Herfindahl index based on audit fees and client locations varies between a minimum of 0.071 and a maximum of 0.982, with the first quartile of 0.125, a median of 0.155, and the third quartile of 0.217.[5]

We identify 273 unique Chinese publicly listed client companies countrywide that are subject to the MPR rule and compare their audit quality both pre- and post-MPR.[6] We require our sample companies rotate out their signing audit partners when they have met the maximum five-year tenure requirement. We also impose the condition that audit *partner* rotation not be accompanied by audit *firm* rotation in the periods before and after MPR to avoid a potentially confounding effect of audit *firm* rotation on audit quality. Following prior research (e.g. Chen et al., 2008; Francis et al., 2013), we use abnormal (discretionary) accruals as our measure of audit quality.

We find that on average MPR has a positive effect on audit quality in the post-rotation years, especially in the second and third years after MPR. When we partition our sample by the provincial AMC levels, we find that the incremental benefit of MPR on audit quality is observed only in low, but not high, AMC provinces in China. We then extend Firth, Rui, and Wu (2012a) to examine whether the interaction of the level of legal development with AMC has an effect on how MPR enhances audit quality. Firth, Rui, and Wu (2012a) show that MPR has a positive effect on audit quality in China only in regions with low levels of legal development. We find that the beneficial effect of MPR is observed in those provinces that not only have low levels of legal development but also low levels of AMC. Our results are robust to alternative audit quality measures such as the discretionary working capital accruals (Carey & Simnett, 2006), different AMC measures, and various pre-MPR periods (one year before MPR and a three-year period before MPR), after controlling for audit firm tenure, client company size, cash flows, industry growth, age, state ownership, and leverage.

Our paper contributes to the literature by bringing together two different streams of extant audit research. One stream examines the effects of MPR on audit quality, but the results are indeterminate. The other stream of literature examines the effect of AMC on audit quality in papers such as Kallapur et al. (2010) and Francis et al. (2013). We contribute to the literature by investigating the effects of MPR on audit quality under different AMC conditions and different levels of legal development. We show that MPR is able to enhance audit quality in Chinese provinces where both of these features are relatively underdeveloped. However,

[5] Kallapur et al. (2010) report US MSA (metropolitan statistical area) Herfindahl indexes of 0.230, 0.252, and 0.293 respectively for the first quartile, median, and the third quartile distributions in the 2000–2006 period. However, these authors study the relation between AMC and audit quality but not in the MPR setting.

[6] Relative to a cross-sectional comparison between MPR client firms and a control sample (e.g. voluntary audit partner rotation or no-rotation sample, as in Chi et al., 2009) our pre- versus post-MPR comparison for MPR firms has the advantage of highlighting the consequence of MPR by eliminating the potentially confounding effects of covariates related to client firms' characteristics.

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