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The Effect of Previous Working Relationship between Rotating Partners on Mandatory Audit Partner Rotation

Min Zhang[a,*], Haoran Xu[b], Xu Li[c]

[a] School of Business, Renmin University of China, 100872, China
[b] School of Accountancy, Dongbei University of Finance and Economics, 116025, China
[c] Faculty of Business and Economics, The University of Hong Kong, Hong Kong, China

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ABSTRACT

This study adds to the literature on mandatory rotation of audit partners in Chinese companies by examining the effect of the pre-rotation relationships between incoming and outgoing partners. We consider the rotating partners to have prior working relationship if they were cosigners of audit reports before the rotation. We find two different outcomes of having prior working relationship: (a) increasing the likelihood that outgoing partners rotate back after the cooling off period, and (b) lower audit quality improvement after rotation. These findings bring into question the extent to which rotating partners with prior working relationships are truly independent.

1. Introduction

Regulators in a number of countries, especially after the major corporate collapses such as Enron and WorldCom in the United States, have expressed great concern about the detrimental effect of long audit tenure on audit quality (e.g., China Securities Regulatory Commission, 2003; Commission on Public Trust and Private Enterprise, 2005; Securities and Exchange Commission, 1994). This is because auditor-client relationships can become increasingly close as audit tenures are extended, leading auditor independence and audit quality to erode (Dopuch, King, & Schwartz, 2001; Mautz & Sharaf, 1961). One potential way to address this concern is to rotate audit partners or audit firms, an idea that has been proposed frequently in recent years. That is, regulators can set an upper bound for audit partner tenure or audit firm tenure. Many jurisdictions, including Australia, China, France, Germany, Taiwan, the United Kingdom, and the United States, have in fact placed limitations on the length of audit partner tenure. However, very few have restricted the length of audit firm tenure (Lennox, Wu, & Zhang, 2014).[1] This is mainly because requiring audit firm rotations would significantly increase audit costs and create unintended consequences such as poorer audit quality (American Institute of Certified Public Accountants, 2011).

Given the prevalence of mandatory audit partner rotation worldwide, recent studies take it as a key agenda to examine the effectiveness of this policy. However, identifying audit partner rotations, which requires acquisition of partner names, is the main constraint in performing such examinations as most countries do not require disclosing the individual information of audit partners. As far as we know, only a few studies have explored this issue. For example, using a sample of firms from Taiwan, where a five-year audit partner rotation came into force in 2004, Chi, Huang, Liao, and Xie (2009) investigate the effect of mandatory audit partner

* Corresponding author.
E-mail addresses: minzhang@ruc.edu.cn (M. Zhang), xhr_bushiwo@163.com (H. Xu), xuli1@hku.hk (X. Li).

[1] European legislation to reform the statutory audit market was adopted in April 2014. According to the new rules, European firms classified as public interest entities (PIEs) will be required to change their audit firms every ten years as a maximum.

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rotation on audit quality. They do not find consistent evidence that mandatory audit partner rotation improves audit quality. Lennox et al. (2014), by using a proprietary dataset of audit adjustments in China, show that audit quality significantly improved in the years immediately surrounding mandatory audit partner rotation.

It is worth noting that most of the prior studies treat all rotations as homogeneous in the role of shaping audit quality. One exception is a recent work by Firth, Rui, and Wu (2012a), who find that Chinese firms with mandatory audit partner rotations are associated with a significantly higher probability of receiving modified audit opinions than firms without mandatory audit partner rotations, and such an association is limited to the firms located in regions with weak legal institutions. Enlightened by Firth et al. (2012a), we decide to examine the changes in audit quality around mandatory audit partner rotations conditioning on whether there are previous working relationships between outgoing and incoming audit partners.[2] We expect that the previous working relationships between outgoing and incoming audit partners would impair the independence of incoming audit partners, thus inhibiting the ability of a rotation to result in a fresh perspective, which is the main benefit of partner rotations. The research perspective of our study, i.e., the relationship between rotating audit partners, is proposed based on the *guanxi* theory. In China, *guanxi* means interpersonal connections (Xin & Pearce, 1996). Once *guanxi* is established between two persons, each can ask a favor of the other with the expectation that the debt incurred will be repaid sometime in the future (Yang, 1994). Several studies show that *guanxi* can affect the behavior of managers and auditors. For instance, Peng and Luo (2000) and Li, Poppo, and Zhou (2008) find that managers' micro interpersonal ties with top executives at other firms and with government officials help firms gain resources, help foster firm growth, and help firms achieve superior performance. Guan, Su, Wu, and Yang (2016) suggest that close relationships between auditors and managers, which manifests in school ties, would impair auditor independence and lead auditors to issue more clean audit opinions. Moreover, some studies find that *guanxi* could weaken the effectiveness of formal institutional arrangements. For example, Firth, Rui, and Wu (2011) document that firms are more likely to obtain favorable appeal results when sued by other firms if their managers, directors, or shareholders have *guanxi* with government.

The disclosure requirement of the Chinese audit market ensures that we can obtain a substantially large dataset to examine the impact of previous working relationships between rotating partners on mandatory audit partner rotation. In China, two audit partners[3] must sign a single audit report. The China Securities Regulatory Commission (CSRC) requires all listed firms to report detailed information on the two audit partners, such as their names, audit firms, and tenure. By hand-collecting these data, we can identify the previous working relationships between outgoing and incoming audit partners. We consider two audit partners who have cosigned an audit report before mandatory rotation to have a previous working relationship, and a mandatory rotation between these two audit partners is defined as a "connected rotation."[4] Connected rotations are widely present in Chinese audit firms. Moreover, based on interviews conducted with audit partners, we find that it is a common phenomenon for outgoing audit partners to participate in incoming audit partners' work, and in some extreme cases, outgoing audit partners even continue to conduct audit practices while incoming audit partners sign the reports afterward.[5]

Using a sample of Chinese firms undergoing mandatory audit partner rotations, we find that outgoing audit partners are more likely to rotate back after the cooling-off period in rotations where rotating audit partners have previous working relationships. The incoming audit partners in such rotations are likely to be less independent, as they are more likely to serve a temporal role and be influenced by outgoing audit partners. Taking the absolute value of discretionary accruals ($|DA|$) and industry-median adjusted non-recurring items (*NRI*) as proxies for audit quality (e.g., Chen, Su, & Wu, 2009; Chi et al., 2009; Myers, Myers, & Omer, 2003), we also find that for non-connected rotations, the audit quality improves, but for connected rotations, the improvement in audit quality decreases significantly and in some cases diminishes completely. Therefore, the evidence in our setting suggests that the close relationship between outgoing and incoming audit partners can erode the positive effect of mandatory audit partner rotation on audit quality.

Our study contributes to the literature in the following ways. First, we extend prior studies on mandatory audit partner rotation by examining whether the impact on audit quality after rotation depends on the relationships between rotating audit partners. Most prior studies investigate the consequences of mandatory audit partner rotation by comparing the audit quality between the pre- and post-rotation periods directly (e.g., Chi et al., 2009; Lennox et al., 2014). Implicitly assumed in these studies is that all rotations are created equal, that is, on average, all rotations either improve or reduce audit quality. We relax this assumption and provide evidence that relationships between rotating audit partners moderate the positive effect of mandatory audit partner rotation on audit quality. Moreover, our investigation is conducted based on the perspective of audit partners. Compared with the perspective of an external legal environment (Firth et al., 2012a), audit partners, who are the target of rotation policy, have more direct impact on audit quality improvement after mandatory rotation. Therefore, our study is helpful for understanding the heterogeneity in mandatory rotation effectiveness as we can see how audit partners evade mandatory rotation directly. Second, this study has policy implications for practitioners such as regulators, audit firms and client managers. We show that, due to the relationships between rotating audit

[2] Su and Wu (2016) find that audit partners are less likely to issue modified opinions to their unforced follower clients, as compared either with all other audits in the same successor audit firm in the same year, or with post-follow audits of forced follower clients, suggesting that audit partners account for relationships when issuing opinions. We also get inspiration from this work.

[3] The two audit partners are the review partner and engagement partner, respectively (Lennox et al., 2014).

[4] Previous academic researchers such as Lennox (2005) have used working relationships as proxies for the close social relationships between auditors and executives of clients.

[5] For example, in 2010, the Shanghai Aijian Corporation (Chinese stock code: 600643) was exposed as being involved in a financial fraud of RMB 1.7 billion during 1998–2002. At the same time, Aijian was audited by Lixin, an audit firm in Shanghai. Although Lixin always issued unqualified opinions, later investigation revealed that the two CPAs, Dai Dingyi and Zhou Qi, did not participate in the audit process, but only signed the audit reports prepared by previous auditors. Source: http://finance.cb.com.cn/13531828/20100305/176801_2.html.