What do Audit Committees Think about Mandatory Audit Firm Rotation?

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Abstract

The debate concerning the advantages and disadvantages of mandatory audit firm rotation (MAFR) is well-documented and on-going, with prior academic research on the issue reporting conflicting results. Although there is a substantial and growing body of recent literature on MAFR, consideration of the audit committee's (AC) perspective on MAFR is absent from this literature. The AC perspective is important as the AC is ultimately responsible for decisions concerning external auditors and has the ability to voluntarily adopt an audit firm rotation policy. To address this gap in the literature, we intend to conduct in-depth interviews with AC members at several firms to directly investigate their perspectives on MAFR. Based on our preliminary results, it appears that AC members support the merits of MAFR. After our full study is completed, we will have obtained significant input from AC members on the advantages and disadvantages of MAFR. The results of our study will be invaluable to regulators in their consideration of MAFR implementation. Our study will also have important practical implications for financial managers as auditor switches can be very challenging for clients and MAFR may change the way clients interact with auditors.

INTRODUCTION

Various groups continue to question whether or not mandatory audit firm rotation (MAFR) would enhance auditor independence and improve financial reporting. The main premise that supports MAFR is that long-term relationships between auditors and their clients compromise the auditor's ability to be objective, therefore impairing auditor independence and increasing the likelihood of audit failures. However, there is little empirical research that supports this claim. Indeed, most recent research has shown that longer auditor-client relationships improve audit quality over time due the auditor's improved knowledge of the client.

Extant academic research on the debate over whether or not to implement MAFR seems to neglect the audit committee's (AC) perspective. This perspective is essential since the AC is an important corporate governance mechanism mandated to monitor external auditor independence from financial management. The AC is ultimately responsible for all aspects of the external audit including appointing the audit firm, overseeing their work, and approving their remuneration. Indeed, the Public Company Accounting Oversight Board (PCAOB) is calling for research on the extent to which ACs have considered implementing a rotation policy, their experiences with such policies, and, if applicable, reasons why they have not considered implementing such a policy (PCAOB, 2011).

There are several issues to consider when assessing the practical feasibility of an audit firm rotation policy. One issue is the tremendous time, effort, and costs required to change auditors (i.e., switching costs). Switching costs include the AC's time in evaluating proposals, the knowledge transfer from the incumbent auditor to the new auditor, and the new auditor's learning curve in attaining an appropriate level of client-specific knowledge. In addition to switching costs, another complicating factor is that there are a limited number of available audit firms that are actually able to meet the needs of many publicly listed companies. A very high percentage of large publicly listed companies engage a Big 4 firm as their auditor, as smaller audit firms have difficulty in providing international resources to support a multinational audit (with the exception of Grant Thornton and BDO). Further complicating matters, many listed companies engage one or more of the other Big 4 firms for non-audit services, potentially preventing them from serving as the incoming audit firm due to independence concerns.[1]

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[1] See, for example, Herbalife's situation at http://blogs.wsj.com/moneybeat/2013/05/02/for-herbalife-finding-a-new-auditor-isnt-easy-as-1-2-3/.

Therefore, the objective of this research project is to conduct in-depth interviews with AC members from several Canadian publicly listed companies to understand their perspective on MAFR. More precisely, we want to determine the AC's perspective on implementing a MAFR policy in their respective corporations. In addition, we want to determine how switching costs might influence the AC's potential decision to adopt a MAFR policy.

BACKGROUND AND MAIN RESEARCH QUESTIONS

The purpose of this section is to briefly summarize the results of prior research on MAFR and its potential impact on audit quality. In addition, we argue that it is important to consider the AC's perspective. Finally, we provide theoretical explanations for audit firm rotation such as agency theory, stewardship theory, and switching costs.

Mandatory Audit Firm Rotation

Many organizations continue to consider whether MAFR is an effective mechanism in improving the quality of the external audit. For example, the PCAOB recently requested comments from the public on whether or not MAFR enhances auditor independence, objectivity, and professional skepticism. The Auditing Standards Committee (ASC) of the American Accounting Association responded to this request and cautioned the PCAOB against additional auditor rotation regulation, since there is a lack research that shows a positive impact of MAFR on independence, objectivity, and professional skepticism (Jones et al. 2012).

The concern of the PCAOB is based on the assumption that a long-term relationship between auditors and their clients would cause the auditor to be less independent and therefore hinder the auditor's ability to be objective. However, Jones et al. (2012) assert that there is very little research that supports this claim. In fact, Myers et al. (2003) and Kaplan and Mauldin (2008) found results that contradict this claim. They found earnings quality to be higher with longer term auditor firm-client relationships because auditors with longer tenure put greater constraints on managers. The ASC also believes that clients might cooperate less with audit firms that are forced to switch (Jones et al. 2012). Other research shows that many audit failures occur soon after a client changes audit firms (Davis et al. 2009; Gul et al. 2009).

To help determine the advantages and disadvantages of MAFR, Casterella and Johnston (2012) conducted an extensive literature review of 24 recent studies on MAFR. The majority of these studies use archival data and the results mostly point to the negative effects of MAFR on audit quality. Interestingly, however, when the authors remove the studies that use data based on *voluntary* audit firm changes and only consider *mandatory* auditor switching studies, the results lend support for the positive effects of MAFR. Their explanation for this finding is that studies that find a positive relationship between audit firm tenure and audit quality among voluntary changers might suffer from self-selection bias (i.e., firms that voluntarily switch audit firms after a short tenure might already have audit quality issues that are not related to an auditor switch).

Therefore, there is no consensus on the effectiveness of MAFR and additional investigation seems warranted – ideally from a new perspective. One viewpoint that appears to be absent from the majority of studies is that of the AC. The AC perspective is important because it is a governance mechanism with a responsibility to oversee the external audit including the relationship between management and the external auditor. If MAFR could help improve audit quality, an AC would most likely implement its own (voluntary) rotation policy. If they do not see the need to do so, however, it would be important to understand why.

Theoretical Explanations for Perspectives on a Rotation Policy

The AC is responsible for the appointment, compensation and oversight of the external auditors (SOX Section 301 in the US and NI 52-100 in Canada). ACs have become more diligent and active in the post-SOX period (Cohen et al. 2010) and interviews with AC members show that some members stress the importance of monitoring auditor independence (Gendron et al. 2004). The fundamental theory that helps justify the existence of the AC is agency theory. Agency theory predicts that managers are opportunistic and that shareholders need the protection from managers (agents) who do not always act in the best interest of owners (principles) (Fama and Jensen 1983). According to agency theory, the interests of owners and managers are by definition conflictive. Within this agency framework, the Board of Directors delegates some of its responsibility to the AC (comprised of independent board members) which is responsible for the oversight of the external audit along with other responsibilities (Turley and Zaman, 2004). The external auditor collaborates with the AC in order to reassure shareholders (owners) as to the credibility of the financial information.

An opposing model to agency theory is stewardship theory which posits that the relationship between shareholders and managers is less conflictive. According to Donaldson (1990), there is no inherent conflict between shareholders and management and the governance objective is to find an organizational structure that allows for the collaboration of different activities in order to meet the overall objectives of the company. Therefore, according to this theory, management seeks to maximize collective interests. Consequently, being representative of the interests of shareholders according to stewardship theory, the AC and the external auditor should not have conflict with management but rather have a collaborative interest for the common good of the corporation. Therefore, we propose that agency theory would predict the need for MAFR whereas stewardship theory would predict that MAFR would not be necessary.

In addition to these two opposing theoretical perspectives, we propose an additional factor that might influence the decision to adopt a MAFR policy: switching costs. In the service marketing literature, switching costs are related to customer satisfaction and loyalty and are defined as costs that customers incur when they change service providers (Lee et al. 2001). Interestingly, these authors demonstrate that the impact of switching on client satisfaction is affected by market structure. If the marketplace has few service providers available, switching costs should not influence the switching behavior as much as when there are many service providers. In the case of the market for audit services, a very high percentage of large publicly listed companies use one of the Big 4 audit firms, as these firms are the only firms that are capable of meeting their needs. The number of available audit firms could be reduced even more if a company uses one or more of the other Big 4 firms for non-audit services. If so, they might not be able to use them for audit services due to independence concerns, further restricting the marketing offering.

This review of the literature and discussion of theoretical and practical factors that may impact rotation policy perspectives motivates the following four research questions:

1. What are AC members’ perspectives on MAFR?
2. Is auditor independence important to AC members?
3. If so, what mechanisms are AC members using to ensure auditor independence?
4. How might switching costs affect a rotation policy decision?

Also, to provide further justification for our research questions, there is a call for further research into audit committee responsibilities including the oversight of the relationship between the external auditor and management (DeZoort et al. 2002). In addition, there is a request for AC research using the interview method (Beasley et al. 2009).

METHOD

We plan on conducting face-to-face interviews with AC members from 20-25 Canadian publicly listed companies. We will use a structured interview guide whereby the participants will be asked open-ended questions. The structured approach will allow us to compare results among the participants. We will use appropriate qualitative research methods to determine common themes. In addition, we may use archival data available in proxy statements and other annual disclosures to corroborate audit committee activities.

PRELIMINARY RESULTS

We conducted two interviews as a pre-test to test our interview guide as well as to provide us with some preliminary data, which will help guide our future interviews. The two AC members interviewed were from the same audit committee and the organization was a non-for-profit (NFP) in the health services sector. The government policy requires the NFP to request proposals from prospective audit firms every three years. However, they are not required to change firms.

DISCUSSION

The objective of this research proposal is to determine the AC perspective on MAFR. The AC should have a vested interest in maintaining auditor independence, since they are ultimately responsible for overseeing the external audit process on behalf of their corporation. Therefore, it is important to understand how important auditor independence is to them and, to the extent that it is, what mechanisms they are using to ensure this independence. If auditor independence is important and they do not implement a MAFR policy within their organization, there must be some good reasons for this decision. These reasons are important for regulators to know. The AC members' insight might provide good support for MAFR or, on the other hand, provide substantial reasons for not implementing MAFR.

Therefore, we will conduct 20-25 face-to-face interviews with AC members to determine their perspective on MAFR and the influence of switching costs on their behavior. Our preliminary results based on interviews with two AC members lend support to the importance of switching firms after 3-5 years, since the participants both feel that after a few years, the auditor will become overly accustomed to the client and therefore less inquisitive. The participants did say that changing firms comes with significant switching costs including time and effort in adjusting to the new audit firm. However, interestingly, the participants also felt that some aspects of switching costs were not only tolerable – they were desired – since it is the extra effort at the beginning of the audit firm-client tenure that forces the new audit firm to ask new and more questions. Based on these two interviews, it is possible that agency theory (and not stewardship) best describes the audit firm-client relationship and MAFR would be a good way to ensure high audit quality. On the other hand, participants also stressed the importance of a collaborative effort between the auditors and the management team, so the conflict might be only a question of outside perception and that internally the relationship is cooperative. These two theories will be examined in our study.

This study will contribute to the overall MAFR debate. The AC perspective seems to be absent in the literature and yet the AC is ultimately responsible for overseeing the effectiveness of the external audit – including the relationship between the audit firm and management. If an AC is not implementing its own rotation policy internally, there must be reasons why and these reasons are important to uncover. Our study will have important practical implications for financial managers as auditor switches can be very challenging for clients.

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