Academic Report Questions Benefits of Auditor Term Limits (July 24, 2015)

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Today's News

Audit Practice News

Academic Report Questions Benefits of Auditor Term Limits

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Summary: *An experiment using decision-making gamesmanship found that auditors will be less independent when faced with clients' questionable accounting decisions if they are forced to rotate every few years. Auditors are more likely to show independence and challenge clients' accounting judgment if they do not have to rotate, the academics who conducted the experiment said.*

An American Accounting Association (AAA) academic research paper questioned the logic behind mandatory audit firm rotation.

Some investor advocates and regulators believe auditor-client relationships, once they last more than a few years, undermine an audit firm's independence and lead it into accepting a client's questionable decisions to protect the revenue from client fees. Term limits are seen as a means toward breaking this pattern and giving auditors freedom to challenge a company when its accounting practices are questionable.

"Professional skepticism requirements are intended to elevate auditors' skepticism of their clients and, ultimately, audit quality," said the paper published in the July-August 2015 issue of the AAA's Accounting Review. "This benefit disappears and even reverses when auditors rotate. That is, rotation and a skeptical mind-set interact to the detriment of audit effort and financial reporting quality."

According to the paper, mandatory rotation improves audit quality when an auditor believes the client is honest, but the effect is reversed when an auditor thinks that the client is dishonest. The study equates skepticism to an auditor's view that the client is dishonest.

The findings are based on behavioral research and a lab experiment by Kendall Bowlin of the University of Mississippi, Jessen Hobson from the University of Illinois at Urbana-Champaign, and David Piercey of the University of Massachusetts in Amherst.

"Regulators appear not to have considered that the frame auditors use to evaluate management representations can vary between assuming potential honesty to assuming potential dishonesty," the study said.

Auditors, knowing that they will not be in a long-term engagement with a client, are "likely to perceive themselves to be less competent in evaluating the honesty or dishonesty of the [corporate] manager relative to auditors who do not rotate," the paper said. "Rotating auditors would find it difficult to garner psychological support for the probability of manager dishonesty, leading them to be less likely to choose high levels of audit effort than non-rotating auditors."

The study comes four years after the PCAOB undertook a project to foster auditor independence by issuing a preliminary rulemaking document, **Concept Release No. 2011-006** , *Auditor Independence and Audit Firm Rotation*. The August 2011 release sparked a heated debate about whether forcing public companies to change auditors every few years would improve audit quality and strengthen investor protections.

The vast majority of about 700 comment letters challenged the premise that term limits could improve audit quality. Auditors, public companies, and corporate directors on audit committees complained that the requirement would drive up costs and cause major disruption without much benefit.

With strong industry opposition and the House of Representatives threatening in 2013 to write a law to block the PCAOB from issuing a mandatory rotation rule, the plan was ultimately shelved.

The researchers' conducted a 90-minute experiment with 226 college students that paired them off and assigned one student the role of a corporate manager and the other the role of an auditor. Half the participants were rotated or changed partners while the other half stayed with the same partner through 20 rounds.

When auditors didn't have to rotate, the experiment found that the ones who were more skeptical were considerably less likely than the less skeptical auditors to choose low-effort audits. But, when the auditors had to rotate, those who were skeptical were substantially more likely than their less skeptical counterparts to put little effort in the audit work.

Without the mandatory rotation, the combination of managers who engaged in aggressive reporting and auditors who put in a low effort occurred significantly less often. When rotation was mandated, aggressive reporting was combined more frequently with low-effort auditing than it was with skeptical auditing.

"We employed techniques of experimental economics to pare decision-making down to the bare bones of gamesmanship, so that cause and effect were quite clear," Bowlin said. The findings "have close parallels in the maneuvering that goes on every day between corporate managers and their external auditors, thereby providing us with insight into the basic psychological processes at work in those interactions."