



## Audit retention versus audit rotation – an update of the debate

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### **Abstract**

**Purpose:** In this paper, an update is provided on the on-going debate between audit retention and audit rotation in different parts of the world.

**Design and Methodology:** This update is provided based on a systematic review of recent scholarship that have explored the supposed benefits or drawbacks of audit rotation amidst a climate of declining confidence in audited financial statements due to a series of financial scandals over the last few years. 28 articles were examined along four key categories, including the geographical distribution of the articles, article type, research themes and research methods.

**Findings:** The findings of the review revealed that the debate between audit rotation and retention has no end in sight with empirical studies finding conflicting results regarding the merits or demerits of adopting a mandatory audit rotation regime in various countries. A recurring message amongst many of the studies is that perhaps time has come for the auditing profession to seek an alternative solution for maintain auditor independence.

**Practical Implications:** A recurring message amongst many of the studies is that perhaps time has come for the auditing profession to seek an alternative solution for maintaining auditor independence.

**The Significance of The Study:** This study reveals that auditor independence cannot be obtained merely by regulation. This is evidenced by the fact that audit-related financial scandals have continued to occur over this long period of time, despite the adoption of mandatory audit rotation in many parts of the world.

## **Introduction**

In this paper, an update is provided on the ongoing debate between audit retention and audit rotation in different parts of the world. This update is provided based on a systematic review of recent auditor rotation scholarship (henceforth referred to as AR research) that have explored the supposed benefits or drawbacks of audit rotation amidst a climate of declining confidence in audited financial statements due to a series of financial scandals over the last few years. On one side of the debate are proponents of mandatory audit rotations as a means of mitigating the potential loss of auditor independence which they argue occur as a result of prolonged familiarity between auditors and their clients (Chi et al., 2017; Cameran et al., 2017, Wilson et al., 2018). On the other side of the debate are those who argue that mandatory audit rotations increase audit costs, and lead to a loss of audit expertise which is obtained when audit firms service their clients over an extended period of time (Allam et al., 2017; Nguyen & Kend, 2017; Tian & Xin, 2017). In short both opponents claim that their approaches which are polar opposites will lead to improved audit quality. It is hoped that a review of the empirical evidence on this issue will grant insight into which side of the debate the pendulum is currently swinging towards.

The rest of the paper includes a section discussing the methodology adopted for the systematic review, followed by a section discussing the findings of the review and their implications. A concluding section ends the paper.

## **Methodology**

In conducting this systematic review of AR research, this study adopted the “systematic quantitative assessment technique” (SQAT) developed by Pickering and Byrne (2014). SQAT is systematic in the way papers are assessed to determine their inclusion or exclusion in the review process, and the focus is on peer-reviewed original journal publications so as to maintain a high quality of papers (Pickering & Byrne, 2014). SQAT enables the researcher to identify “important geographic, scalar, theoretical and methodological gaps in the literature” (Pickering & Byrne, 2014, p. 11). The researchers found SQAT to be logical, simple to use, and easily replicated, which are all important components of a systematic review.

SQAT recommends five important steps in conducting an effective systematic review. Each step and how it was applied in this study is described in Table 1. A total of 28 peer-reviewed English AR articles met the selection criteria from the ten databases.

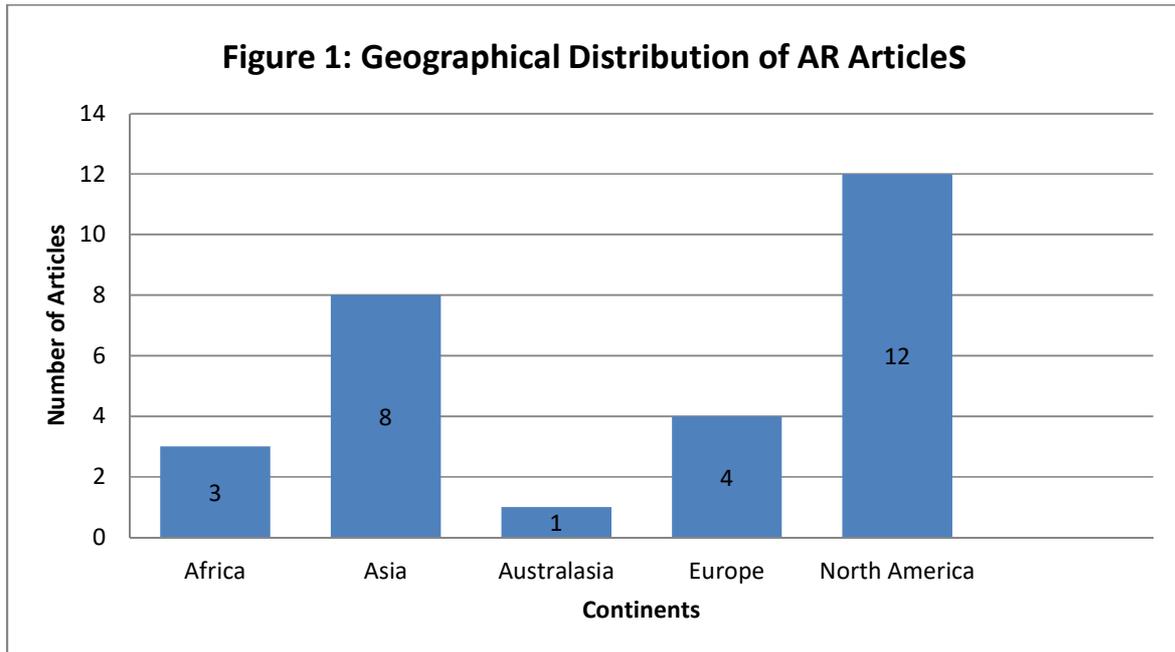
**Table 1:** Description and application of SQAT

	Step	Application in current study
1.	Define topic	Improving audit quality
2.	Formulate research questions	Five research questions: 1. What is the geographical distribution of AR research articles? 2. What kind of AR articles were published? (Conceptual vs. Empirical) 3. What are the specific themes these papers explored? 4. What were the findings for each theme? 5. What research methods were utilized to conduct the research?
3.	Identify key words	“audit”, “auditor”, “rotation”, “retention”
4.	Identify and search databases	1. 11 databases utilized: Elsevier; Springer; Wiley; Taylor and Francis; JSTOR; Emerald; Sage; Inderscience; American Accounting Association; HeinOnline; 2. “All in title” search using four search combinations: a. “audit” + “rotation” b. “auditor” + “rotation” c. “audit” + “retention” d. “auditor” + “retention”
5.	Read and assess publications	1. Abstracts of papers found were read to ensure that they were dealing with auditor rotation or retention issues. 2. Book chapters and conference proceedings were not included; only peer-reviewed conceptual and empirical papers.

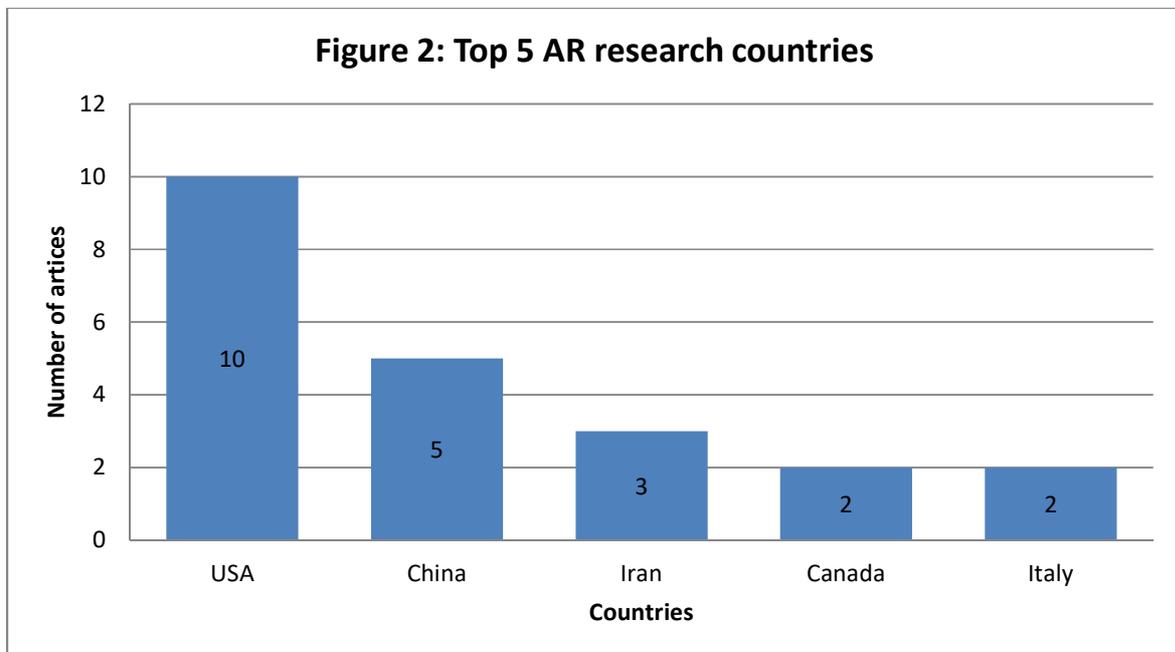
## Findings and Discussion

### Geographical Distribution of AR Articles

Figure 1 presents the geographical distribution of the 28 AR articles reviewed in this study. It can be observed that North America has the greatest number of articles published (12), followed by Asia (8), Europe (4), Africa (3), and finally Australasia (1). The South American continent was not represented in this review, and this serves as a geographical gap in AR research which auditing scholars should address. It is important that the voice of this continent be represented in the on-going debate between audit rotation or retention. It must be clarified that perhaps this continent is represented in Spanish or Portuguese articles, but they are represented in the English research media, whilst Asia where English is also not the primary language is.



From a country perspective, 12 countries were represented in the systematic review of AR research. Figure 2 presents the top five countries where AR research was conducted. It can be seen that the USA had the greatest number of articles (10), followed by China (5), Iran (3), Canada (2) and Italy (2). The remaining 7 countries only had one article representing them (The European Union, Nigeria, Egypt, Tunisia, Australia and South Korea).

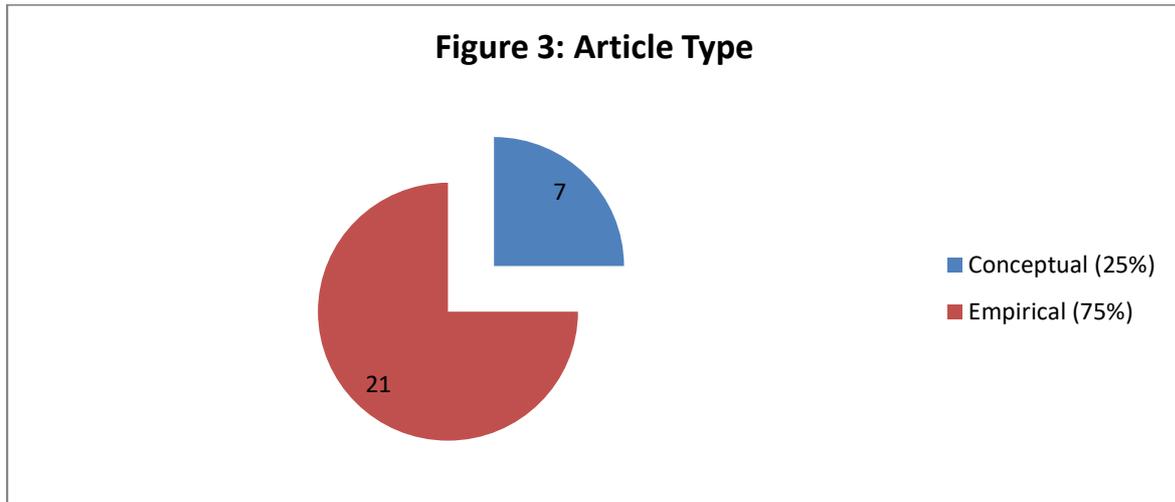


According to worldatlas.com, there are currently 196 countries in the world, including Taiwan (World Map, 2017). As mentioned previously, only 12 of these countries had AR articles published in them in this paper's systematic review. Of course, as this paper only included articles published in English, this statistic must be taken with that in mind. Despite this caveat, many countries of the world are not represented in AR research. Audit rotation or retention is a hot-button issue that is integral in the restoration of the integrity of the auditing profession. Considering how many stakeholders rely on the quality of audited information to make life-changing financial decisions, it is very important that researchers in these countries conduct studies to determine the effectiveness of audit rotation in stemming the tide of financial scandals that have been occurring over the years.

### **Article Type**

The 28 articles were divided into two categories: conceptual and empirical. Conceptual articles were defined as those that provided a theoretical discussion on AR, whilst empirical articles were those which collected data qualitatively or quantitatively in order to test a particular hypothesis in the real world (Conceptual and Empirical Research: Which is Better, 2016). Figure 3 presents the breakdown of the 28 articles based on this categorization.

It can be seen from figure 3 that the vast majority of articles reviewed (75%, 21 out of 28) are empirical in nature, whereby the authors explore the effects of auditor rotation on various aspects of the audit profession such as audit quality (Cameran et al., 2016), audit fees (Ferguson et al., 2017), and the perceptions of various stakeholders (Reid & Carcello, 2017). This imbalance represents an obvious gap in AR research which future researchers should address. Whilst it is commendable AR researchers are empirically assessing the impact of audit rotation on various aspects on the auditing profession, it stifles the ability to critically assess whether or not audit rotation is the only solution to maintaining auditor independence. Conceptual research into AR will facilitate such critical inquiry into the theoretical rationale of AR and allow researchers to conceivable develop other concepts that might be more effective in maintaining and improving auditor independence.



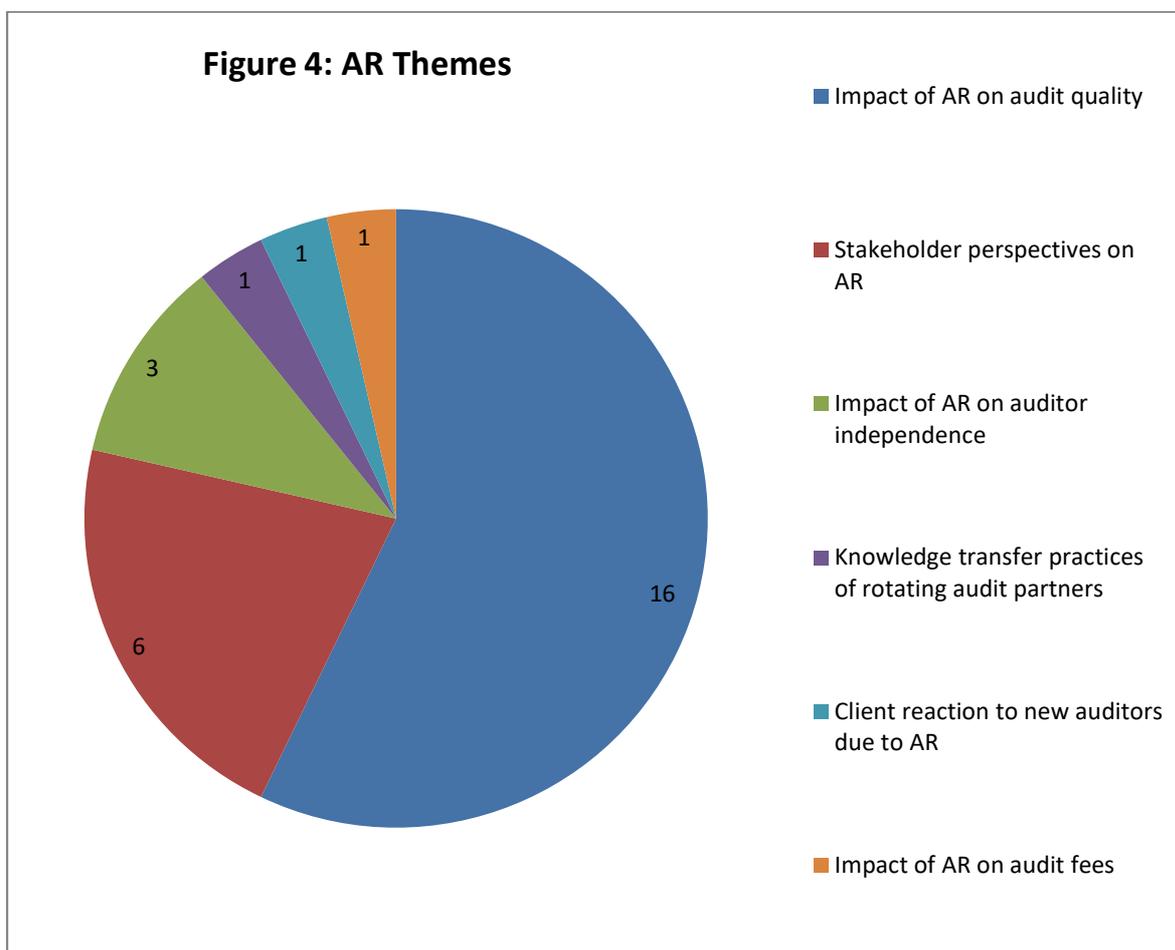
### AR Research Themes

Figure 4 reveals that six AR themes were explored by the 28 articles reviewed in this paper. More than half of the articles (57%; 16 out of 28) dealt with the impact of AR on audit quality. There were three main findings: some studies found that AR led to high levels of audit quality (Kim et al., 2015; Mohammadi et al., 2015; Cameran et al., 2016); others found that there was no increase in audit quality due to AR ( Jenkins & Vermeer, 2013; Omri & Abdennebi, 2014; Velte & Freibank, 2015). Another group of studies found that in situations where previously rotated auditors come back to their former clients after a required “cooling-off period”, audit quality tends to decline (Firth et al., 2012; Zhang et al., 2017). What can be observed from all these findings is that there is no consensus amongst scholars on whether or not AR has a positive or negative impact on audit quality. This lack of consensus creates a worrying dilemma for regulators trying to protect the independence of auditors. Do they push on with the global trend of mandating AR or do they start to look for alternative solutions?

The second most common theme was stakeholder perspectives on AR, with 6 articles of the 28 reviewed articles included (21%). These articles solicited the opinions of various stakeholders on AR. For example, loan officers perceived that legislating AR would increase auditor independence (Daniels & Booker, 2011), whilst audit clients had an expectation that AR would improve audit quality (Mahdavi & Daryaei, 2017).

On the other hand, auditors perceived that AR reduces audit quality due to a loss of experience (Mohamed & Habib, 2013). The majority of alternative solutions to AR offered by these auditors focused on strengthening the audit committee, thus suggesting that regulators

should shift from auditors to the client in their bid to ensure auditor confidence (Williams & Wilder, 2017). As for audit committee members, they were completely opposed to mandatory AR as they felt it threatened their authority to make audit firm appointment decisions (Fontaine et al., 2016). Ultimately, they felt that AR was an unnecessary intervention, and that their professional judgment and observations are more effective in ensuring auditor independence (Fontaine et al., 2016). Finally, US investors also reacted negatively to events that increased the probability of mandatory AR being legislated (Fontaine et al., 2016).



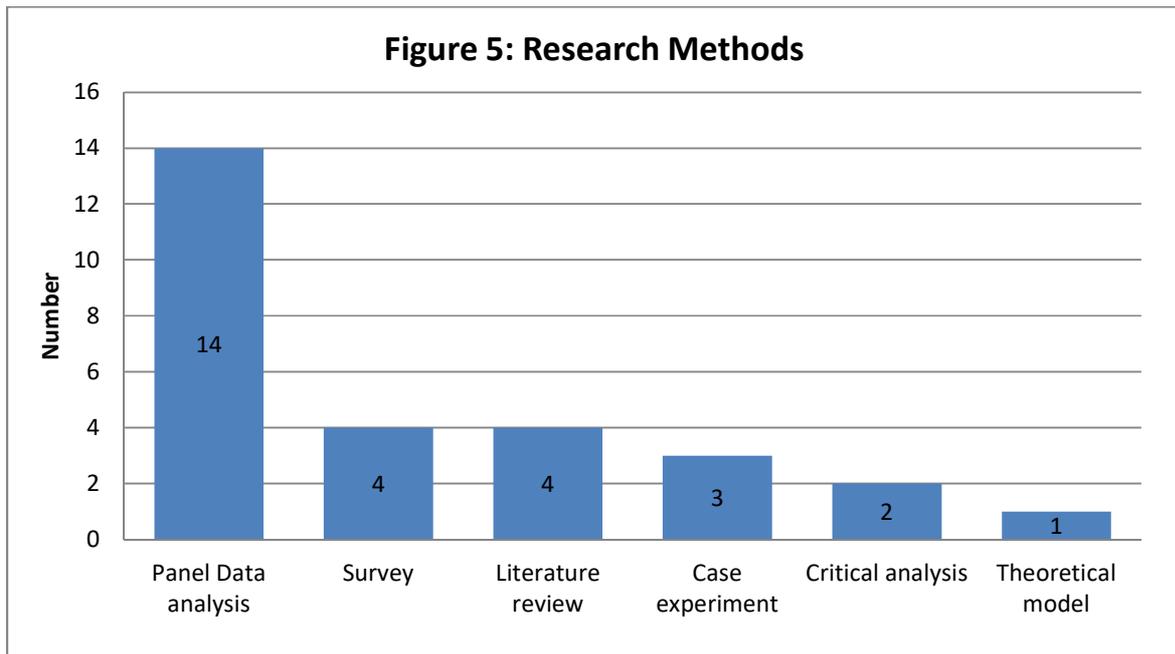
Studies exploring the impact of AR on auditor independence were the third most common theme amongst the 28 articles reviewed (3 out of 28). The findings were inconclusive, with one study concluding that AR should be mandated to protect the interest of all stakeholders (Burke & Lee, 2015), whilst another study found that there is no significant relationship between audit firm rotation and auditor independence (Kighir, 2013). Edwards (2014)

posits that there is a need to ask fundamental questions regarding whether or not AR is the solution for ensuring auditor independence. He concludes that the real answer to ensuring auditor independence may not be found in rules such as AR, but in commitment to professionalism and in one's oath to duty and integrity (Edwards, 2014).

The last three studies reviewed in this paper focused on knowledge transfer practices of rotating auditing partners (Daugherty et al., 2012), client reaction to new auditors due to AR (Schmidt & Cross, 2014) and the impact of AR on audit fees (Ferguson et al., 2017) respectively. Daugherty et al. (2012) opined that in order to ensure that valuable knowledge is successfully transferred to a rotating partner in a regime where audit partner rotation is mandated, planning, strategy, documentation and deep interaction are invaluable. As for Schmidt and Cross (2014), they found that clients in Canada tend to be more accommodating to newly rotated audit partners as compared to the previous audit partner. Finally, Ferguson et al. (2017) found that in Australia, mandatory AR led to significant increases in audit fees. The authors, Ferguson et al. (2017), concluded that with mounting evidence of AR compliance costs and with conflicting evidence on the benefits of AR, there is a need for policy-makers to seriously discuss the viability of AR as the solution for ensuring auditor independence.

### **Research Methods**

In this section, the objective was to identify the primary research method utilized in each of the 28 AR articles reviewed in this paper. Figure 5 provides a summary of the findings. Exactly half of the studies reviewed (14 out of 28) adopted panel data analysis via a logistic regression (Ferguson et al., 2017), a multivariate regression (Zhang et al., 2017), chi-square distribution test (Mohammadi et al., 2015) or correlation (Reid & Carcello, 2017).



Surveys (Williams & Wilder, 2017) and literature reviews (Velte & Freidank, 2015) were jointly the second most common research method, both with 4 articles utilizing this method. This was closely followed by case experiments (Bowlin et al., 2015) which three articles utilized. Two articles utilized critical analysis (Edwards, 2014; Burke & Lee, 2015), while one article developed a theoretical model to examine the impact of AR on audit quality (Mahdavi & Daryaei, 2017).

### Conclusion

This paper reviewed 28 peer-reviewed journal articles dealing with AR, in order to provide an update on the debate between auditor rotation and auditor retention that has been going on for decades. These articles were examined along four key categories, including the geographical distribution of the articles, article type, research themes and research methods. The results of the review were discussed and directions for future research were provided. The findings of the review revealed that the debate between audit rotation and retention has no end in sight with empirical studies finding conflicting results regarding the merits or demerits of adopting a mandatory audit rotation regime in various countries. A recurring message amongst many of the studies is that perhaps time has come for the auditing profession to seek an alternative solution for maintain auditor independence. This is considering that the debate has been going on for decades, whilst audit-related financial

scandals have continued to occur over this long period of time. This is despite the adoption of mandatory audit rotation in many parts of the world.

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