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AUDITOR TENURE, AUDITOR ROTATION AND AUDIT QUALITY- A REVIEW

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ABSTRACT: *The arguments on auditor tenure and rotation revolved around ensuring auditor independence and promoting audit quality. Two hypotheses tend to explain the effect of longer auditor tenure. The auditor independence hypothesis argues that longer tenure decreases audit quality and financial reporting because of the impairment of auditor's independence while the expertise hypothesis posits that longer tenure improves audit quality through learning. Nevertheless, the auditor tenure be long enough for auditors to bring their competence and expertise into the auditing process and also familiarize with the audited firm and environment. Apart from the few countries where there have mandatory audit rotations, it is still under experimentation in many other countries Moreover, the results of the impact of audit firm/partner rotation on audit quality have been mixed and inconclusive. And specifically, one of the leading advocates for mandatory auditor rotation through the Sarbanes Oxley Act of 2002, the United States, has recently made a U-turn through appropriate amendment to the mandatory rotation of the audit firm in 2013.However, in April,2014 the European Union parliament voted in favour of 2011 proposal to force European companies to hire new auditors after six years with a four year cooling period. Therefore, we conclude that the mixed evidence and the recent regulatory changes on auditor rotation provide opportunities for future studies on auditor tenure, auditor rotation and audit quality.*

KEYWORDS: Auditor Tenure, Auditor Rotation, Audit Firm, Audit Partner, Audit Quality, Auditor Independence

INTRODUCTION

A lot of debates have evolved in the academic literatures and accounting profession on the relationship among auditor tenure, auditor rotation and audit quality (Petty and Cuganesan, 1996, Jenkins and Vermeer,2013; Blandon and Bosch,2015).At the core of the argument is the question of auditor's independence in the auditor-client relationship; that is, the auditor's ability to maintain an unbiased standpoint in performing his audit assignments, issuing audit opinion and ensuring high quality audit report. This is because audits add credibility to financial information by providing independent verification of management-provided financial reports, and helping to reduce investors' information risk (Watts and Zimmerman, 1986; Johnson et al, 2002; Mansi, Maxwell and Miller 2004).Besides, participants in the capital market value audit quality (Teoh and Wong,1993;Moreland,1995;Khurana and Raman 2004; Pittman and Fortin, 2004) because auditor's independence and competence affect the credibility, reliability and quality of the auditor's report (Watkins, Hillison and Morecroft, 2004).

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It has been argued for long (though with limited empirical evidences) that longer audit tenure could impair auditor independence and lower audit quality since a longer auditor-client relationship may breed over-familiarity and make the auditor to lose his "honest disinterestedness" (Mautz and Sharaf 1961;Shockley,1982;Vanstraelen 2000; Carey and Simnett 2006, Gul *et al.*2011,Blandon and Bosch,2015). The auditor could accede to the interest of the client's management accounting and reporting choice in order to retain the client that the audit plan becomes stale (US Senate 1976:21; AICPA, 1978 & 1992; SEC 1994; Arrunada and Paz-Ares 1997; Morrill, 2008).There is also less likelihood of qualified auditor's opinions in a lengthy auditor- client relationship (Vanstraelen,2000; Carey and Simnett,2006;Blandon and Bosch,2015)

According to DeAngelo (1981a:186), audit quality is the market assessed joint probability that a given auditor will both (1) discover a breach in the client's accounting system and (2) report the breach. She argued that longer-term audit firms have higher audit quality due to a greater level of independence because any given client is immaterial to a large firm audit practice. The General Accounting Office –GAO (2004) says audit quality refers to the auditor conducting the audit in accordance with Generally Accepted Auditing Standards (GAAS) to provide reasonable assurance that the audited financial statements and related disclosures are (1) presented in accordance with Generally Accepted Accounting Principles (GAAP) and (2) are not materially misstated whether due to errors or fraud.

Audit quality measures include proxies such as : (1) Accruals (Becker et al, 1998, Francis et al, 1999, Francis and Kristhen,1999; Bartov et al, 2000; Myers et al 2003; Francis and Wang 2007). (2) Abnormal working capital accrual or AWCA (Defond and Park 2001) (3) Discretionary accruals (Francis and Krishnan,1999,Johnson,Khurana and Reynolds,2002, Hamilton et al, 2005 Carey and Simnett,2006) (4) Audit fees and hours (Deis and Giroux 1996, Caramanis and Lennox 2008) (5) Earnings response coefficients (Ghosh and Moon,2005) (6) Propensity to issue a modified audit opinion (Lim and Tan 2008, Firth, Rui and Wu,2012).The audit quality is determined not only by auditor independence but also by factor such as the quality of accounting standards, accounting education, auditor expertise, audit committees, corporate governance, auditor discipline, liability and nature of GAAP. Institutional (prevailing economic conditions, the way that firms are governed) and regulatory frameworks, the legal environment (investor protection, capital market pressures, legal enforcement) and capital market development factors also help to explain differences in accounting quality across countries (Ball, Kothari and Robin, 2000, Khurana and Raman, 2004, Choi and Wong, 2007, Francis and Wang, 2008, Firth et al, 2012)

Since audited financial statements are the joint product of auditor-client negotiation process, there have been great concerns for the preservation of the auditor's independence which is at the heart of the integrity of the audit process. Auditor's independence is fundamental to the reliability of auditor's report and has been adjudged as the cornerstone of the accounting profession and one of its most precious assets. Hence its importance has been reiterated and emphasized over time by oversight boards and professional literature (AICPA, 1999; POB 2000). Following the need to preserve and reduce threats to auditors independence, proponents of auditor's rotation and regulators have pushed for mandatory auditor's rotation- whether mandatory audit firm or engagement partner's rotation (Azizkhani et al, 2006). And recently, due to corporate scandals and collapses that cast doubts and eroded audit quality (Hoyle 1978; Imhoff 2003), which also revealed compromise or deficiency in auditor's

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independence, the need for the rotation of the audit partner was advocated in order to enhance audit quality (GAO, 2003).

In the US, Section 203 of the Sarbanes-Oxley (SOX) Act of (2002) specifies that the lead audit or coordinating partner and the review partner must rotate off the audit every five years to restore confidence to financial reporting. Various studies conducted are inconclusive on the success of the SOX Act. There are conflicting results or findings on whether firms have engaged in less or more earnings management in post SOX. In particular, Zhou (2008) in trying to reconcile conflicting prior findings on post SOX found that firms are not only reporting more conservatively (i.e. lower discretionary accruals) but also engaging in less overall earnings management. A material weakness was more perceived by the Certified Public Accountants (CPAs) in the internal control area required by section 404 of the SOX Act (McEnroe, 2009). In fact, the presence of SOX 404 material weaknesses was also found to have allowed for greater earnings manipulation using discretionary accrued (Epps and Guthrie,2009).The European Commission (2010) in their Green Paper and the US Public Company Accounting Oversight Board (PCAOB) proposed the mandatory audit firm rotation in mid 2011.Chasan (2014) argued that effort by the PCAOB to impose mandatory auditor rotation on public companies failed 2 years when the US House of Representatives prohibits audit firm rotation by amending Section 103 of the Sarbanes-Oxley Act of 2002 in 2013.

Despite the persuasive arguments for and against auditor rotation, Morrill (2008) remarked that considering researches on audit firm rotation had not improved audit quality. However, the basic issues or arguments are (1) what are the effects of auditor tenure (short or long) and auditor rotation (voluntary or mandatory) on audit quality? (2) Do auditor tenure /auditor rotation improve or impair the auditor's independence (3) Do the costs of long-term auditor-client relationship outweigh the cost of changing or switching? (4) What are the risks to audit quality posed by a new auditor as well as implications of low-balling? The paper contributes to the intense debates over auditor tenure and rotation and the quality of financial reporting in that some countries and requires their companies to rotate (either voluntarily or mandatorily) their auditors periodically.The rest of the paper is divided into five sections: Section 2 reviews the relationship between auditor's tenure and audit quality. Section 3 considers the impact of auditors' rotation on auditor independence and audit quality. Section 4 looks at cost of audit switching and the consequence of low-balling while Section 5 is the conclusion and recommendations.

Auditor tenure and audit quality: the intriguing relationship

The main argument has been whether the length or duration of audit firm with a client affects the quality of the audit (Mautz and Sharaf, 1961; U.S Senate, 1976; Shockey 1981; Lyner and Roma; 2004). The argument is conflicting. While some researchers argued that longer tenure (5-10 years) decreases audit quality because of the impairment of auditor's independence (auditor independence hypothesis), others believed that longer tenure improves audit quality through learning (expertise hypothesis).Azizkhani et al (2006) posit that the auditor's independence incorporates three different arguments as to what audit quality might decrease as auditor tenure increases. These include auditors may: (1) create economic dependence on the client which may impair auditor's independence (DeAngelo 1981a, 1981b; Magee and Tseng, 1990; Raghunathan et al, 1994) (2) develop a learned confidence in the client (familiarity threat) which may result in auditor not testing financial assertions (Hoyle,1978; Shockley,1981) (3) psychological dependence or the development of personal relationship to the extent of developing bonds of loyalty, trust or emotive relationships (Arel et al, 2005).

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The auditor's expertise hypothesis is based on information asymmetry in the auditor-client relationship. This reduces over time as the auditor acquires more knowledge of the client which helps him/her to detect material misstatement in the financial report. It implies that audit quality is lower during the early years of the auditor-client relationship and the quality increases as the length of auditor tenure increases due to reduction in the information gap between them (Beck et al 1988, Solomon et al, 1999, Geiger and Raghunadan 2002).

Auditor tenure has two dimensions: the tenure of the audit-firm and the tenure of the individual partner engaged in the audit, particularly the engagement partner. More emphasis has been focused on the audit-firm tenure because of the difficulties in identifying the engagement partner. Empirical evidences of the effects of audit-firm tenure on the audit quality are mixed and conflicting (see table 1) .While some of the studies reports that audit quality decreases with increased audit-firm tenure, others like Casterella et al., (2002), Davis et al (2002), Johnson et al (2002), Myers, Myers, and Omer (2003), Ghosh and Moon (2005), Choi and Doogar (2005) and Gunny et al (2007) report a positive relationship. Basically, most studies found that audit failures are more likely to occur with short audit-firm tenure of between 2-3 years (St.Pierre and Andersen, 1984; Stice, 1991; AICPA, 1992; Raghunathan et al., 1994; Walkel et al., 2001; Geiger and Raghunathan, 2002; Carcello and Nagy 2004, Gul et al, 2006 & 2007).

Similar empirical researches on the effects of long audit tenure of the engagement audit partner on the audit quality produce mixed and inconclusive results (see Chen et al, 2004; Chi and Hong, 2005; Cary and Simnett, 2006). While some studies show positive association between audit partner tenure and audit quality measured by discretionary accrual (Manry *et al*. 2008,Chi et al., 2009; Chen et al., 2010), others recorded a negative association (Carey & Simnett, 2006; Hamilton et al., 2005; Fargher et al., 2008).

Equally, there are mixed and conflicting results on the empirical relationship between auditor's tenure and board rating, earnings management, earnings response coefficient, nature of audit opinions issued, frequency of restatements of financial statements and cost of debt. For instance, Myers et al (2003) found that accruals (proxy for earnings management) decrease with auditor tenure whereas Davis et al (2002) also using accruals arrive at different conclusion. Also, Vanstraelen (2000) found long auditor tenure significantly reduces auditor's willingness to qualify audit reports whereas Geiger and Raghunandan (2002) found the opposite. Myers et al (2005) stated that the relationship between auditor tenure and the propensity for restatement could be positive or negative and they concluded the evidence provided no clear support. Ghosh and Moon (2005) found that earnings response coefficient increases with the length of audit firm tenure, consistent with earnings being greater as auditor tenure increases. They also found that the influence of earnings on Standard and Poor (S& P) stock rating increased with the length of audit firm tenure. They found no evidence of audit firm tenure impacting on the influence of earnings on S & P debt raking unlike Mansi et al (2004) who found that increasing auditor tenure is associated with higher S & P debt rating. Gul et al (2009) examined whether industry specialization of auditors and low balling effect affect the association between auditor tenure and earnings quality. They found that the association between shorter auditor tenure and lower earnings is weaker for firms audited by industry specialists compared to non-specialists.

Crabtree et al (2006) examined newly issued bonds in the period 1990 and found that auditor tenure was positively related to ratings received. Brandon and Mueller (2002) investigated whether jurors' judgments of auditor's blameworthiness are influenced by the length of

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auditor's tenure with a client. They found that longer tenure has a positive impact on perception of competence but a negative impact on perception of independence. Therefore, from a litigation perspective, the auditor's tenure with a client is a double-edge sword. Ruiz-Barbadillo et al (2008) examine whether long-term audit engagement improves quality of the service or increase the possibility of a company engaging in opinion shopping. They found that the longer the audit engagement, the lower the probability of opinion shopping.

Table 1 Summary of researches on the effect of auditor tenure on audit Quality.

Measure	Study	Year	Result	Longer tenure of audit-firm on audit quality
Relationship between audit failure and auditor tenure	Casterella et al (2002)		Found quality of Audit decrease due to audit firm failure to detect fraudulent financial reporting or issue going concern opinion	Decrease
Audit-quality Going-concern Qualification	Choi and Doogar (2005)	1996-2001		Decrease
Auditor-tenure, auditor independent and Earnings management	Davies et al (2002)		A positive relationship between audit-firm tenure and discretionary accruals.	Increase
Auditor-client relationship and the quality of earning.	Myers et al (2003)	1998-2001	Found a negative relationship between audit-firm tenure and earning quality measured by discretionary accruals and special items.	Decrease
Audit- firm tenure and quality of financial report.	Johnson et al (2002)	1986-1995	1) Short audit tenure of 2-3 years associated with lower quality financial reports, unexpected accruals higher in early years. 2)No evidence of reduced financial reporting quality for longer audit-firm tenures (of 9 or more years).	Decrease Increase
Audit-tenure and perception of audit quality	Ghosh and Moon (2005)	1990-2000	Positive relationship between audit firm tenure and several measures of reliance on reported earnings. (proxy for audit quality).	Increase
Association between type of audit opinion on financial statement immediately prior to bankruptcy and auditor.	Geiger and Raghunandan (2002)	1996-1998	(1) Auditors with longer tenure more independent and not associated with higher likelihood of audit reporting failure.	Increase
Audit tenure a fee dependence a timely recognizing losses	Gul et al (2007)		Quality of financial is lower when auditors tenure is short than when the tenure is long	Increase

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Association between auditor tenure, industry expertise and fees	Gunny et al (2007)		Audit tenure has a favorable impact on audit quality by instigative audit and serious impact for the non –Big 4 auditor.	Increase
Audit partner,audit-firm and discretionary accrual.	Chen et al (2004)	1990-2001	Length of engagement audit partner is negatively related to the absolute value of discretionary accrual.	Decrease
Association between industry specialize-tion and low balling and auditor tenure and earnings quality.	Gul et al (2009)		Found association between shorter auditor tenure and lower earnings quality weaker for firms audited by industry specialists than non-specialists.	Increase
Audit-firm tenure and fraudulent financial reporting	Carcello and Nagy (2004)	1990-2001	Found that the probability of fraudulent financial reporting is highest early in the audit firm's tenure (i.e the first three years and is not significantly higher for instances of longer audit engagement.	Increase
Discretionary accrual Audit firm and audit partner.	Chi and Huang (2005)		Report that the level of abnormal accruals is lower in the early years of audit tenure (either firm or engagement partner) than the latter years of firm tenure.	Decrease/ Increase
Audit partner and Audit tenure.	Carey and Simnett (2006)		Found that the probability of a going concern qualification and beating (missing) earnings benchmarks are negatively associated with engagement partner tenure, suggesting an independence concern with engagement partner tenure.	Decrease
Effect of Audit change and audit fee, hour and audit quality.	Deis and Giroux (1992)		In reviewing audit quality letters produced by a public audit agency concluded that audit quality decreases as tenure increases.	Decrease
Audit tenure and audit Qualifications in a low litigation risk setting:An analysis of the Spanish market	Blandon and Bosch (2015)	Spanish listed companies 2001-2009	Result shows the likelihood of audit qualifications decreases with audit tenure and rejection that higher accounting quality is associated with lengthy audit engagements	Decrease

Adapted from Morill (2008)

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Auditor rotation, auditor independence and audit quality

From the auditor's independence hypothesis associated with auditor tenure in the auditor-client relationship, the academics and accounting professions have debated and advocated that auditor rotation could help to maintain auditor's independence, objectivity and professional skepticism (Mautz and Sharaf 1961; U.S. Senate, 1976, Hoyle,1978; Bates et al, 1982, AICPA, 1992, 1995; Arrunada and Paz-Ares 1997; SEC, 1994; Vanaco, 1996; Pettey and Cuganesa, 1996; Dopuch et al, 2001; Hussey and Lan 2001; Gietzman and Sen, 2002, ICAEW, 2002, Healey, 2003; ICC 2005; PCAOB,2011).However, there is the argument whether the auditor could truly be independent in the auditor-client relationship given the pressure to maintain their stream of income in a mandatory rotation setting (Bazerman, Morgan and Loewenstein,1997).

Auditor rotation includes audit-firm and audit partner rotation. The logic behind partner rotation is to bring in fresh perspective to the audit and encourage a "fresh viewpoint" which enhances the technical rigour of an audit (AICPA,1978, 1992; ICAEW 2002; Dopuch et al 2001; ICC 2005). Seidman (1939: 424) describes rotation as: "a new auditor, like a new broom, will make a clean sweep and can pick up things not caught by the predecessor." Basically, the researches of the effects of audit partner rotation on audit quality are mixed. For instance, Monroe and Hossain (2013) conclude that the implementation of mandatory audit partner rotation has improved audit quality because audit firms were more likely to issue qualified going-concern opinions for financially distressed companies following mandatory partner rotation. Hamilton et al (2005) and Fargher et al (2008) also report a positive association between audit partner changes and audit quality. Firth et al (2012) find mandatory audit partner rotation are associated with higher modified audit opinion proxy for audit quality especially for less developed regions. But Carey and Simnett (2006) report a significant negative association between mandatory audit partner rotation and audit quality when the tenure is more than seven years. Again, Chen et al (2008) and Chi et al. (2009) find that audit quality deteriorates after partner rotation using discretionary accruals as a measure of earnings quality in Taiwan

Bae, Kallapur and Rho (2013) argued that auditor rotation could affect audit quality in the following ways: (1) Long tenure might induce complacency among auditors and make them identify with the client, reducing their independence and could result in stock option backdating (Ouyang and Wan, 2013) (2) Mandatory rotation could keep auditors on their toes since they know that their work will be reviewed by a fresh pair of eyes.(3) Mandatory rotation might create a misalignment- if there is a single auditor best suited for a client, then the client has to forego that auditor's services and settle for another less-well-suited auditor when subjected to mandatory rotation (Pitt 2012:20). (uniquely-well-suited-auditor argument) and (4) Rotation could affect audit market concentration and competition, which in turn might affect audit quality

Mandatory rotation could also affect audit quality through its effect on the audit market structure and the increase or decrease in the choice of qualified auditors for clients (Bae et al,2013). It was argued by the Metcalfe commission (1977) that rotation will allow more audit firms to enter the market thereby expanding the choice available to clients. However, excessive competition may be bad and mandatory rotation may worsen the problem (Cohen Commission, 1978).Mandatory rotation eliminates the expectation of a continued stream of revenues and thereby liberates auditors from the pressure to bend to clients' will to prevent the loss of the revenue stream (Bazerman, Morgan and Loewenstein 1997, PCAOB 2011),

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decreases the penalty for loss of reputation, gives retiring auditor the incentives to clean up before they are rotated out. However, Pitt (2012) pointed out that auditors will slack off and have lower rather than higher incentives to maintain audit quality if they lack any expectation of continued revenues. In fact, the decline in effectiveness of the old auditor is linked to familiarity with with clients, less willingness to challenge them and escalation of commitment (Bazerman, Loewenstein and Moore.2002)

Following the financial reporting scandals and collapses in the United States, there have been calls for mandatory auditor rotation to reduce the possibility of fraud (SOX Act 2002, GAO, 2003; NYSE,2002, TIAA-CREEF, 2004). Also, it has been argued that auditors will be in a stronger position to resist management pressure and be independent and exercise more objective professional judgment if there is mandatory rotation (Brody and Moscove,1998, Chung, 2004). Wolf et al (1999) suggested that to maintain auditor's independence and objectivity, audit firms should periodically relinquish their clients. However, only a selected countries and oversight boards have implemented mandatory audit partner or audit-firm rotation such as: Italy (1974), Brazil (1999), France (1998,2003), Spain (1989), Singapore (2002), China (2003-2005), United Kingdom (2003), Austria (2004), South Korea (2006), and Canada (before 1991). Austria and Canada abandoned mandatory rotation in 2005 and 1991 respectively (Cameran et al, 2005). By July 2003, mandatory rotation of audit partners for all public companies was being considered by Canada's securities regulator (GAO, 2003). Bae et al (2013) argued that Spain announced but never implemented mandatory rotation. Carrela et al (2007) argued that at no stage was mandatory rotation of audit firms ever enforced on Spanish auditors but the whole gimmick was a politicized process. The reasons for abandoning the requirements for mandatory audit firm rotation in Spain and Canada were related to its lack of cost-effectiveness, cost, and having achieved the objective of increased competition for audit services. In Japan, the Amended Certified Public Accountant Law was passed in May 2003, and beginning on April 1, 2004, audit partners and reviewing partners were to be prohibited from being engaged in auditing the same listed company over a period of 7 consecutive years. In Netherland, the maximum period for rotation of the engagement audit partner was reduced from 7 years to 5 years while the maximum period for rotation of the other key audit partners is 7 years. There is presently no limit period for the rotation of the audit firm or partner in Nigeria.

Recent regulatory issues issues on Audit Rotation

The AICPA (1978) practice section requirement for mandatory partner rotation In the US, was every seven years. But the Sarbanes Oxley (SOX) Acts of 2002 required the lead audit partner and audit review partner to be rotated every five year for public companies engagement. Again the US House of Representative introduced the integrity or job protection bill during the first session of the 113 US congress in 2013 to amend the SOX Act of 2002 which prohibit the PCAOB from requiring public companies to use specific auditors or require the use of different auditors on a rotating basis. It is seven years in the UK for listed companies. Formerly rotation was not longer than seven years in Australia but it is now five years or less since 2004. In April, 2014, the European Parliament voted in favour of new rules (proposal of 2011) to force European companies to hire new auditors at 10 - to 24-year intervals. This new rule extends the six years period of mandatory auditor rotation proposed in 2011 with a cooling period of four years (Chasan, 2014).

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The effects of audit firm rotation (voluntary and mandatory) on auditor's independence and audit quality

Mandatory audit rotation has been suggested as a means of strengthening independence, reducing the incidence of audit failure and improving the quality of audits. However, there are research evidences that show rotation increases audit costs and prices, reduces auditor incentives to invest in specific industries, destroys the knowledge of client companies that an audit firm usually accumulates over a period of years and distorts the competition in the market (Cameran et al, 2005).It has been argued by academic researchers that attempts to achieve increased independence through mandated rotation of audit firms was likely to have other unintended and undesirable consequences (Ball, Glover, Jamal, Kasam, Kouri, Paterson, Radhakrishnan and Sunder, nd). Harris and Whisenant (2012) investigate the debonding effect of a mandatory rotation policy (that is the goals of rotation rules enhancing auditor's independence in an audit market) and the low client specific knowledge effect (audit quality before and after mandatory audit rotation).They conclude that although the quality of audit market appears to improve on average from enactment of mandatory rotation rules, there were evidence of lower audit quality in both years .

Over the recent decades, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have set standards that de-emphasize verifiability in favour of the mark-to-market valuation, no matter how illiquid the market may be. It has also adopted a practice of writing detailed standards in its attempt to close loopholes but ends up creating new ones. These have made the auditors work more complex. Thus mandating audit firm rotation at the expense of other determining factors of audit quality would be a bad policy and may impair auditor independence, weaken audit expertise, undermine corporate governance and impair audit quality. This supports the survey findings of Fortune 1000 public traded companies by the GAO in 2003 that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional financial costs and the loss of institutional knowledge of the public company's previous auditor of record as well as the current reforms being implemented.

Church and Zhuang (2006) developed a theoretical model to prove that mandatory rotation is preferable if rotation period is long, start up costs are high, cost of biased report is high, auditor learning is dramatic in improving audit efficiencies and the manager is myopic (focused on short-term payoff). According to Cameran, et al (2008), most of the studies on audit firm rotation were performed under a voluntary rotation regime or under a "forced rotation setting" and the findings showed that audit quality may or may not appear to deteriorate with or immediately after the auditor change.Using Italy as one of the countries where mandatory audit firm rotation has been effective for over twenty years, their findings support that (1) audit quality tends to improve rather then worsen over time and (2) comparing the effects of voluntary and mandatory auditor's change on audit quality, they found that while a voluntary change tends to improve audit quality, a mandatory change dampen quality.In fact, they found no evidence of any beneficial effect of mandatory audit firm rotation on audit quality. Similarly, Morrill (2008) in analysing various studies on auditor rotation came to the conclusion that audit-firm rotation does not improve audit quality but that the audit quality seems to deteriorate when the auditor is replaced. It is argued that differences in audit quality under the two regimes may be consequent of the auditor's perceptions and motivation. This may affect auditor's incentives in performing audit

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activities especially in mandatory audit rotation (Magee and Tseng, 1990, Ghosh and Moon 2005; Cameran et al, 2008).

Cameran et al (2005) review the findings and conclusions of 26 reports by regulators or other representative bodies from around the world. Of the 26 reports, 22 concluded against the benefits of mandatory audit-firm rotation and while only 4 were in favour. These four are: Assirevi (Italian Association of Audit Firms), the Galgano Commission, Monetary Authority of Singapore (MAS) and the US independent Conference Board and Galgano Commisssion are in Italy where firm rotation is mandatory for some companies (i.e. all listed companies). Moreover, in Singapore (area of influence of MAS), the same rule is effective for incorporated banks. The study also considered 34 academic studies which comprised 9 opinions and 25 empirical-based evidences. The majority did not support mandatory audit-firm rotation. They found that studies based on empirical evidence had a larger majority against firm rotation (76%) than opinion based studies (56%) (Cameran et al,2005).

Elitzur and Falk (1996) model proposed that when total auditing engagement is known and finite, the level of planned audit quality will decrease over time and the level for the last period is the lowest. However, the model did not consider the reputation effects of an audit failure which may have significant impact on the auditor's future payoffs from other clients and the learning process which can lead to improved audit quality, independent from the existence of a finite engagement time (Carcello and Nagy, 2004, Geiger and Raghunandan,2002, DeAngelo,1981). Also, it has been suggested that decrease in audit quality may be consequent of an auditor becoming less independent from the client's firm and getting into a closer relationship with the managers (Brody and Moscove, 1998).

Many of the studies do not support auditor rotation as it eventually leads to decrease in audit quality if new auditors takes over (Geiger and Raghunandan,2002; Myers et al 2003; Johnson et al 2002; Carcello and Nagy, 2004; Mansi et al, 2004; Ghosh and Moon; 2005).However, the following studies support auditor rotation, in that they perceive new auditors are better then long-term auditors- Hamilton et al (2005) by using unexpected small, signed and positive accruals; Carey and Simnett (2006), in meeting or beating earnings bench marks; and Gate, et al (2007) found confidence in financial statement increased following rotation; Gietzman and Sen (2002) found that if the audit market is thin mandatory rotation increases the independence and risk of collision.Nagy (2005) found insignificant relationship between short audit tenure and discretionary accruals for small US companies. Vanstraelen (2000) found long-term relationship leads to unqualified report. The findings of Knechel and Vanstraeelen (2007), Blouin, Grein and Rountree (2007), Johnson et al (2002) when they used persistence of accruals as measure of audit quality were neutral; that is, neither support or refute rotation. Firth et al (2012) examine the the effects of the various forms of audit rotation on audit quality find that firms with mandatory audit partner rotations are associated with a significantly higher likelihood of an modified audit opinion (MAO) than are no-rotation firms in China. They find no evidence that other forms of auditor rotation (i.e., mandatory audit firm rotation and voluntary audit partner rotation) have an effect on the issuance of a MAO. Overall, they document a positive effect of mandatory audit partner rotation on audit quality in regions with weak legal institutions but fail to find robust evidence that mandatory audit firm rotation is significantly superior to other forms of auditor rotation. The stock market seems not to value auditor's rotation (SDA,2002). In fact, the market reacts more strongly to earnings audited by long-term auditors than new auditors. This suggests that auditor retention improves the perceived credibility of earnings and financial

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reporting (Ghosh and Moon,2005).The number of lawsuits has been found to increase with new engagements (St Pierre and Anderson, 1984).

TABLE 2 Summary of audit quality research study for audit firms rotation

Measure of audit quality	Study of year	Sample /notes	Result	Support Rotation (*Cost of Switching excluded)
Issuing going concern opinion prior to bankruptcy	Geiger and Raghunandan (2002)	US public companies (1996-1998)	Long- term auditors better than new auditors.	No
	Knechel and Van Straeelen (2007)	Large Belgian private firms (1992-1996)	Long- term auditors same as new auditors.	Neutral
Total Accruals	Myers et al (2003)	US public companies (1998-2001)	Long- term auditors better than new auditors.	No
Discretionary Accruals	Johnson et al (2002)	US public companies (1986-1995)	Long- term auditors better than new auditors.	No
	Myers et al (2003)	US public companies (1998-2001)	Long- term auditors better than new auditors.	No
	Blouin et al (2007)	Ex. Arthur Anderson Publicity traded clients	Long- term auditors same as new auditors.	Neutral
Persistence of Accruals	Johnson et al (2002)	US public companies (1986-1995)	Long- term auditors same as new auditors.	Neutral
Alleged fraudulent reporting	Carcello and Nagy (2004)	US public companies (1990-2001)	Long- term auditors better than new auditors.	No
Confidence in financial statements	Gates et al (2007)	Experiment on MBA students	Long- term auditors perceived as worse than new auditors.	Yes

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Earnings response coefficient	Ghosh and Moon (2005)	US public companies (1990-2001)	Long- term auditors perceived as worse than new auditors.	No
Cost of debt	Mansi et al (2004)	US public companies (1974-1998)	Long- term auditors perceived as worse than new auditors.	No
Abnormal accruals	Carey and Simnett (2006)	Australian firms	Long term auditors is better than new auditor	No
Beating earnings benchmark (Break-even profit or prior year earnings)		Australian firms	New auditor perceived as better than long term auditor	Yes
Unexpected accrual (small signed and positive) and more conservative reporting	Hamilton et al (2005)	Australian firms (1998-2003) (audit partner changes)	New auditor perceived as better than long term auditor	Yes
Investors perception of audit quality using earnings response coefficient	Chi, et al (2005)	Taiwanese companies 2004	New audit partner perceive to increase audit quality	Yes
Does Mandatory Audit Firm Rotation Really Improve Audit Quality	Cameran et al (2008)	Non-financial Italian listed companies 1985-2004	Long-term auditor perceived better than newauditor	No

Adapted from Morill (2008)

Auditor change or switch and audit quality

In considering rotation or change of audit firm or partner, the cost of switching auditors, the risk to audit quality posed by the new auditor and low balling must also be examined. Usually, the costs are likely to be higher when an audit firm rather then an existing partner, is removed. Hamilton et al (2005) argued that because of the direct financial costs associated with a new audit firm in familiarizing itself with client's business environment, internal controls and financial reporting policies are higher than partner change. It is not surprising that regulatory reforms have focused on mandatory partner rotation rather than mandatory audit firm rotation. The USA, UK and Australia (though legislation) have introduced mandatory audit partner rotation (US Senate 1976:21; SOX 2002 Australia CPAICC, 2001& 2004).

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There are continuing debates among academic researchers on the basis for voluntary auditor change.There are suggestions that companies change audit firm in order to reduce audit fees; other argued that it is meant to improve the quality of the financial reports, for opportunistic reasons which is a concern for regulators (SEC, 1988), and consequence of management motivation for opinion shopping. Empirical evidences to support above claims are not clear-cut (Defond,1992; Francis and Wilson, 1988; Johnson and Lys, 1990). Also, there are arguments that auditor change occurred due to the divergent opinions between managers and auditor on the appropriate application of GAAP, especially when auditors applies more income decreasing (more conservative) GAAP rules (Antle and Nalebuff, 1991; Dye, 1991; Krishnan,1994;Krishnan and Stephen 1995). Defond and Subramanyan (1998) showed that firms which switch from Big 6 to non-Big 6 audit firms appear to implement more liberal accounting, evidenced by unexpected accruals. That is, discretionary accruals are found to be income decreasing in the last year of the audit service but insignificant in the first year of the new auditor's service. Where there is perceived high litigation risk, auditors prefer conservative accounting but managers prefer a less conservative successor when they dismiss the incumbent auditors. Kim et al, (2004) found that where a designated auditor is appointed by securities regulator in Korea, and not by the client firm, relatively lower discretionary accruals was reported, suggesting auditor designation improves the independence of designated auditor. Chung (2004) reported similar findings.

Fargher, Lee and Mande (2005) examined the relationship between partner tenure and a measure of unexpected accrual for Australian firms between 1990 and 2002.They found positive association with absolute value of unexpected accruals but negative association with signed unexpected accruals. Chen et al (2004) reported a negative relationship between audit partner tenure and the absolute value of unexpected accruals. Chi et al (2005) found higher quality auditing for firms subjected to mandatory rotation for sampled Taiwanese firms from 1990 to2001. Hamilton et al (2005) using signed unexpected accruals found evidence of lower signed unexpected accruals at the time of rotation for the Big 5 auditors in Australia. Earning quality was not significantly different in rotation years. There were also more conservative contemporaneous earnings when partner rotation occurs due to regulatory initiatives and the political environment.

Cameran et al (2008) found that accruals before a voluntary change in a mandatory rotation environment (Italy) were less conservative (ie income increasing) than after the audit change. They found no evidence of any beneficial effect of mandatory auditor change on audit quality. Jackson et al (2007) on investigating mandatory audit –firm rotation for Australian firms from 1995-2003 found that there are minimal, if any, benefits of imposing mandatory audit firm rotation. They argued that given the costs involved in switching auditor, it does not appear that mandatory audit firm rotation would be beneficial to the market.

Cost of audit switching costs and low-balling

The cost associated with the switching of auditors by client is enormous because of the direct financial cost and the potential costs associated with reduced familiarity and the risk to audit quality posed by a new auditor due to less competence. O'Leary (1996) argued that in considering compulsory rotation of audit firms, the benefits of mandatory rotation are outweighed by the associated costs. Mandatory rotation is found to generate high social cost (SDA,2002). A partner's switch or change is usually less costly than audit firm switch. And unless the client becomes very risky or ceases to fit the existing audit-firm's client portfolio,

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it is unlikely that an audit firm will propose that the client makes a change of audit-firm (Hamilton, et al 2005; Shu, 2000; Krishnan and Krishnan, 1997).

Audit firms are more likely to propose a change of audit partner to an audit client firm if the change will help the audit firm to manage and develop key staff and partners. More experienced partners can be rotated to problem clients to restrain aggressive accounting and to reduce audit risk. Clients could oppose switch or change of audit partner if they foresee disruption to the smooth running of the audit or potential difficulties in gaining approval of contentious accounting policies (GAAP) and estimates. Managers of client firm may restrict an incoming audit firm or partner who wishes to adopt a more conservative (income decreasing accruals) approach after the switch or auditor change. At the same time, it was found that auditor are willing to terminate their relationship with clients that prefer low quality of financial reporting or more risky clients (Ghosh and Moon, 2005).

Apart from the client's firm, the auditor may also want to retain their new client. This may lead to the competitiveness of low-balling (which is pricing the initial audit fee below the avoidable costs of the audit) in order to attain the client. Low-balling is a natural competitive response of auditors in order to obtain a new client and the rights to future quasi-rents to be received from that client (Simon and Francis, 1988, Ettredge and Greenberg, 1990; Deis and Groux 1995, DeAngelo 1981c). Dye (1981c) argued that low-balling makes auditor to report more favourably on the financial condition of clients in order to enjoy more-quasi-rent from the client. Auditors want a client long enough to be able to offset the high initial start- off costs of engagement.This practice could impair the auditor's professional judgment and independence. Financially stressed firms were more likely to switch auditors then non-stressed financials firms (Krishnan, 1994; Krishnan and Steven, 1995).However, switching companies were less likely to have their modified report removed than un-switched companies (Geiger, et al 1998). Researches on auditor switching suggest companies are not generally successful in obtaining more client reporting treatment from their new auditors.

CONCLUSION AND RECOMMENDATIONS

In this paper, we have considered a critical review of some of the empirical and theoretical researches on auditor's tenure, auditor's rotation and the quality of financial reporting. Although there is conflicting evidences on the association between auditor's tenure and the audit quality, shorter auditor tenure tends to be associated with low audit quality whereas longer tenure results in high audit quality. Similarly, there is no general support for rotation of audit firm or partner. In fact, from researches reviewed, long-term auditors tend to be better than new auditors and hence they provide no support for rotation because of the conclusion that auditor rotation will lead to lower audit quality. When the cost of switching or changing auditors and consequences of low balling are considered, decisions about audit rotation will not be favourable in enhancing audit quality. The call by SOX Act of 2002 and other regulatory and oversight bodies for the mandatory rotation of the lead or review partner may be far from guaranteeing the audit quality and curtailing the incidences of fraud and earnings management practices (Daniel,2009).Rotation of audit firm actually impairs audit quality by enabling more frequent opinion shopping and low-balling. It also discourages accretion of audit expertise, downgrades the valuable signal of auditor change, and shifts even more resources from substantive verification and tests to marketing of audit services (Ball et al, nd). Although, long-term audit engagements is argued to impair auditor

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independence, the rotation of the audit firm or partner does not seem to have a better effect on audit quality

While the push for auditor tenure and mandatory auditor rotation have often been hotly debated or canvassed following corporate frauds and collapses in order to preserve auditors' independence and guarantee increased audit quality, we would advocate auditor tenure long enough to enable bring their expertise and competence to bear on the auditing engagement as well as familiarize with client's audit environment. This may also make auditors to build on their reputations and avoid low-balling. In addition, the institutions and code of corporate governance mechanisms must be strengthened to improve audit quality. The independence and capacity of the audit committee must be enhanced to perform their oversight functions of the auditor's work effectively and efficiently and ensure auditors independence. The accounting and auditing profession must continue to emphasize auditing ethics and education to guarantee best practices by auditors in the profession. Auditors are to be ethical in the conduct of audit engagements. They should consider the rightness or wrongness of their actions, which does not necessarily depend on the consequence of their action but on the fulfillment of the intended duty rather than on the outcome of their opinion.

Moreover, the major accounting standards boards like the FASB/IASB should consider re-writing or issuing standards of financial reporting that will enhance the verifiability of financial reports and improve both accounting and audit quality. They should evaluate the effectiveness of existing requirements for enhancing auditor's independence and audit quality. We also suggest voluntary audit partner rotation within an audit firm as a safeguard to reduce the potential compromise of auditor independence and audit quality. According to Harris et al (2012), to arrest erosion of audit quality around audit firm changes, there might be need for the use of two files by predecessor and successive audit firms or the "four-eyes principles" in the initial audit years.In conclusion, we support the call for caution in the debates and suggest more studies into the proposition for mandatory rotation because of the mixed and inconclusive results (Carrera et al , 2007, Firth et al, 2012) and in some cases deterioration of audit quality after mandatory audit rotation.

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