Loan Officers' Reactions to Audit Rotation

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Abstract

This study explores bank loan officers' perceptions of audit firm rotation using a between-subjects case scenario. We address general issues of rotation and specific aspects of rotation, including the impact of rotation versus no rotation on perceptions of auditor independence and audit quality. Findings indicate that bank loan officers perceive that there is a greater perception of auditor independence and likelihood that errors discovered by the auditors will be reported when a company follows a rotation policy versus when there is no rotation policy.

Key Words: *Audit, Audit Rotation, Auditor Independence, Audit Quality*

Introduction

Recent corporate and accounting scandals shook investor confidence, raised questions about the reliability of financial statements and the potential negative effects of long-term relationships between auditors and their clients. Some view these long-term relationships as a threat to auditor independence (Ryan et al. 2001; Walker et al. 2001; Shockley 1981). Furthermore, they assert that rotation of auditor would lead to higher quality audits since the successor auditors would review the work of the predecessors, thereby motivating the predecessors. On the other hand, others believe that long-term relationships help the auditors to better understand the unique business transactions and identify key audit risks, resulting in higher quality audits (Ghosh & Moon 2005; Myer et al. 2003; Johnson et al. 2002; Stice 1991, Knapp 1991, St. Pierre & Anderson 1984; AICPA 1992).

Requiring audit firm rotation, limiting the number of consecutive years that a particular audit firm can audit a public company, has been discussed as one means of improving auditor independence and reducing the likelihood of audit failures (U.S. Senate 1976; AICPA's Cohen Report 1978; POB 2001; SOX 2002). Audit firm rotation is not a new concept. It has been introduced and implemented in several countries such as Israel, Brazil, Spain and Italy (Catanach and Walker 1999).

There is little empirical research to support or reject the concept of audit rotation (Catanach and Walker 1999). Several bills with provisions dealing with audit firm rotation were heavily debated in the hearing of the Sarbanes-Oxley Act (hereafter referred to as the "SOX") as a means of enhancing auditor independence.[1] However, Congress decided that this issue needed further study and requested the Comptroller General study the potential effects of mandatory rotation on registered public accounting firms. This study empirically investigates whether periodic rotation of audit firms affects perceptions of external auditors' independence and audit quality.

The remainder of this paper is organized as follows. The next section provides background information. This is followed by the method and results sections. The final section covers summary, conclusions, limitations and future research.

Background - Audit Firm Rotation

Over the years, practitioners and academicians have debated the pros and cons of long-term auditor-client relationships. Currently, there are no rules on how long an accounting firm can serve as an auditor for a company. According to GAO, approximately 99% of the Fortune 1000 public companies do not have a policy that requires the periodic rotation of audit firms. The average auditor tenure is 22 years (GAO 2003). KPMG has been the external auditor of record for General Electric for over a century. Deloitte and Touché has been the auditor for General Motor for over eighty-five years (Mason 2004). Presently, Section 203 of the SOX requires audit partner rotation, but it does not require audit firm rotation. According to a survey conducted by

1 The Integrity in Auditing Act of 2002 (referred to as the Nelson-Carnahan Bill) and the Trust and Accountability in Accounting Act of 2002 (H.R. 3970) which stated that auditors should not be considered independent if they provided auditing or consulting services for more than 7 consecutive years.

Accountancy Age (2003), only one of the thirty (30) leading accounting firms supported audit firm rotation.

The AICPA issued a report, "Statement of Position Regarding Mandatory Rotation of Audit Firms of Publicly Held Companies" in 1992. The AICPA strongly opposed mandatory rotation citing that mandatory audit firm rotation was not in the best interest of the public. According to this study, the AICPA examined 400 cases of audit failures between 1979 and 1991. They reported that audit failures seem to occur almost three times as often when the auditor was performing his first or second audit of a company. The study also states that requiring firms to change auditors would increase the risk of audit failures. Auditors would not have sufficient knowledge of the client's business, which is important to identify problems early in a business (AICPA 1992).

On March 14, 2002, James E. Copeland, then CEO of Deloitte and Touché, representing the AICPA in a speech before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, indicates that rotation would increase start-up costs for auditors. He points out that requiring rotation of auditors would mean that institutional knowledge will be lost and on each new engagement the auditors will be climbing a steep learning curve (Copeland 2002).

Not all stakeholders of financial statements see audit firm rotation as a detriment to the public. Eugene Imhoff, Professor at the University Of Michigan School Of Business, believes that rotation of audit firms would be more beneficial to the profession than the new oversight board. Rotation of auditors would be a way the CPA firms can serve as an oversight to review procedures followed and judgment rendered of the predecessor audit firm (Imhoff 2002). Imhoff also notes that requiring the rotation of auditors would also alleviate issues dealing with the revolving-door problem of allowing companies to hire former audit personnel.

On February 27, 2002, John H. Biggs, then Chairman and CEO of TIAA-CREF, which practices mandatory rotation, testified before the U. S. Senate Committee on Banking, Housing and Urban Affairs about the positive aspects of rotation for companies. According to Biggs, if Enron had been required to rotate its auditors every five to seven years, they would not have continued to issue misleading financial information (Biggs 2002). Furthermore, Biggs noted that rotation would also reduce low-balling of other non-audit services and eliminates the revolving door phenomenon (Biggs 2002).

The SOX required the General Accounting Office to study the potential effects of mandatory audit firm rotation on public companies. GAO surveyed and interviewed accounting firms, chief fiscal officers and audit committee chairs of the Fortune 1000 publicly-traded companies. The majority of the largest public accounting firms and the Fortune 1000 companies interviewed agreed that the costs associated with audit firm rotation are likely to exceed the benefits. Many of the participants surveyed indicated that SOX's requirements regarding audit partner rotation (using different individuals within an audit firm) and auditor independence would achieve the same benefits as audit firm rotation (using different audit firms). GAO also interviewed other interested parties (consumer groups, institutional investors, accountants, and etc). The views of these groups were consistent with the overall views of other survey respondents interviewed by GAO. GAO acknowledges that it will take several years of experience with the implementation of SOX before the effectiveness of the act can be fully assessed (GAO 2003).

Research Questions

While this topic has been heavily debated, a definitive answer to the question is still not clear. Numerous researchers have addressed this topic by using accruals-based measurements, (Myers et al. 2003), earning management tools (Ghosh and Moon 2005), financial reporting failures (Carcello and Nagy 2004) and Judges' perceptions (Jennings, et al. 2006). However, because there are no regulatory requirement for audit firm rotation and 99% of the fortune 1000 public companies do not have a policy that require audit firm rotation (GOA 2003), archival data is not available for research in this area.

The profession maintains that auditors must be independent "in fact," and independent "in appearance." In light of recent events, the media and other factors have heightened the awareness of the issue of independence. This has created a perception problem that maintaining independence in appearance has become difficult for some firms. The SEC stated:

> It is therefore not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might be lost. (SEC 2000, 5)

A similar point was expressed in the January 9, 2003 Commission on Public Trust and Private Enterprise's report. The report recommends that audit committees should consider rotation of auditors as a means of enhancing auditor independence and building shareholder confidence in the integrity of the firm's financial statements. The Commission believes that the cost of implementing rotation of auditors will be significantly less than costs the loss of investor confidence due to inaccurate financial statements (Commission on Public Trust and Private Enterprise 2003). Accordingly, our second research question is:

> RQ1: Does the rotation of the external audit firm affect the bank loan officers' perceptions of audit firms' independence?

Corporate scandals and company failures arose following discoveries of accounting errors that contributed to the fiscal crisis in the1980s. In response, the AICPA issued several standard-setting guidelines, seeking to improve financial reporting practices, increase auditor responsibilities, and establish safeguards to ensure audit quality. Numerous academic studies have examined this issue with mixed results. These quality debates usually involve whether the quality of the auditor's work decreases over time.

The term "quality audit" is difficult to quantify. It means different things to different peoples. DeAngelo (1981b) provides one of the most frequently cited definitions of quality. DeAngelo indicates that the quality of an audit is related to whether an auditor will (1) discover an error in the financial statements and (2) report the error in the audit report. DeAngelo reasons that an auditor that lacks auditor independence will be less likely to report a discovered breach, thus reducing audit quality (DeAngelo 1981a).

The audit quality's effects on audit tenure have been researched by various researchers (including Knapp 1991; Deis and Giroux 1992; Catanach and Walker 1999; Copley and Doucet 1993; Johnson et al. 2002; Myers et al. 2003). The findings on how tenure of auditors affects audit quality are diverse. Several researchers have argued that the quality of audits decreases over time (DeAngelo 1981, Deis and Giroux 1992, Raghunathan et al. 1994). In these studies, quality is measured based upon reporting accuracy. This lead to our next research question:

RQ1a: Does the rotation of the external audit firm affect the bank loan officers' perceptions of audit quality?

Method

We use a questionnaire and a between-subjects case scenario for this research, developing two versions of the case. The versions of the case are differing only as it relates to the rotation policy. This section provides details on participants, questionnaire, and pretesting.

Participants

Participants are bank loan officers who were randomly selected from a commercially available database of more than 16,000 bank loan officers throughout the United States[2.] Each loan officer was assigned to one of two versions of the research instrument. We received 212 (24.65% adjusted response rate) usable responses.

Table 1 provides demographic information on respondents. As indicated in Table 1, a majority (78 percent) holds executive banking positions (president & vice presidents). In addition, participants are mostly college educated with 77% having baccalaureate degrees or higher. Finally, participants have significant experience, with 87 percent having over 10 years of banking experience and 67 percent indicating that they had 10 years or more of bank lending experience. The demographic information indicates that the respondents possess the characteristics necessary to make informed judgments on issues address in this study.

Questionnaire

The questionnaire contains two versions of a case scenario with three statements. The case scenario sought to examine whether the bank loan officers' perceptions regarding auditor independence, the potential to discover an error during an audit, and the auditor propensity to report an error, are affected by the rotation of the audit firms (using different firms – hereafter referred to as AFR) versus no rotation of the audit firms (using the same firm – hereafter referred to as NoAFR).

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[2] The mailing list was purchased from Hugo Dunhill Mailing Lists, Inc.

TABLE 1
Demographic Composition of Respondents

	Count	Percentage
Group Size	212	100%
Education Level		
High School	29	13.8%
Associate's Degree	19	9.0%
Bachelor's Degree	122	58.1%
Master's Degree	34	16.2%
Other	6	2.9%
Total	210	100.0%
Current Position		
President/CEO	75	35.9%
Vice President	88	42.1%
Loan Officer	17	8.1%
Credit Analyst	2	1.0%
Other	27	12.9%
Total	209	100.0%
Banking Experience		
Less than 5 years	8	3.8%
5 years, < 10 years	19	9.0%
10 years, < 20 years	44	21.0%
20 years, < 30 years	69	32.9%
30 years or more	70	33.3%
Total	210	100.0%
Lending Experience		
Less than 5 years	38	18.1%
5 years, < 10 years	32	15.2%
10 years, < 20 years	39	18.6%
20 years, < 30 years	55	26.2%
30 years or more	46	21.9%
Total	210	100.0%
Gender		
Male	155	74.4%
Female	54	25.6%
Total	209	100.0%
Age		
Less than 25	4	1.9%
25 to 40	47	22.2%
41 to 55	94	44.3%
Over 55	67	31.6%
Total	212	100.0%

Note: Total by the various categories differed from the group total because respondents did not provide responses to all of the requested demographic information.

Operationally, the primary question is whether an audit firm rotation policy will lead to perception of more independent auditors performing better quality audits either by discovering and or by reporting material errors in the financial statement. We use a between-subjects design with random assignment. Half of the participants receive the scenario that includes audit firm rotation and the other half receives the scenario where there is no audit firm rotation. Version A of the case consists of a short scenario where a publicly-traded company's financial statement has been audited by the same CPA firms for the past twenty-two years. Twenty-two years was used because it is the average length of an auditor-client relationship for Fortune 1000 companies (GAO 2003). Version B of the case is consistent with Version A except the company's external audit firms have been rotated every seven years. After reading the case scenario, the participants mark their responses to three statements (independence, potential to discover the error, and propensity to report an error discovered) using a five- point Likert-type scale, anchor at 1 for Strongly Disagree to 5 for Strongly Agree.

Section C of the questionnaire contains an area for open-ended comments. This section allows the participants to express their views on mandatory audit firm rotation. The participants were asked to provide any additional comments and experiences relating to audit firm rotation for public companies.

Pretesting

We pretested and adjusted the instrument based upon comments from local bank loan officers, accounting professors and Ph.D. students who were also CPAs with experience in public practice. After the adjustments from the pre-testing, we conducted a pilot test with 150 bank loan officers drawn randomly from the population of the commercial banks database. Minor changes were made to the instrument.

Results

This section reports the results of the research questions. Table 2 contains results relative to RQ1 of the questionnaire, (case scenarios). We performed content analysis relative to the comments made by the participants. Table 3 contains comments relative to comment section of the questionnaire (comments made by participants).

Research Question 1

As shown in Table 2, we conducted an independent t-test to compare the differences in the means scores for AFR and NoAFR Scenarios. T-test results indicate that, at 95% confidence level, there was a significant difference ($p=.004$) between the means responses of the NoAFR and AFR cases of the perception of independence. Bankers were more concerned whether the CPA firm was independent in the NoAFR scenario compared to the AFR scenario (3.07 versus 2.66). Additional analysis indicated that about 40% questioned the firm's independence (agree or strongly agree) in the NoAFR scenario versus only 25% in the AFR scenario. The findings suggest that the respondents' perceptions of independence were impacted by the presence of an audit firm rotation policy versus no rotation policy. Loan officers were less likely to question the CPA firm independence when the audit firms were rotated as compared to the audit preformed by the CPA firm, which was not rotated.

Table 2, Panel B reports the results of an independent t-test relative to perceptions of discovering errors in the financial statements (Q12). The data indicated that there was not a significant difference (p=.547) in the loan officers' perceptions of whether the CPA firm would discover material errors in the financial statements when the audit firms were rotated compared to when the audit firms were not rotated. As reported in Panel B, the NoAFR group mean (std. dev.) was 3.00 (.991) and the AFR group mean (std. dev.) was 2.91 (1.075). Thus, the perceptions of loan officers relative to discovering errors in the financial statement were only slightly modified when a company employs the same audit firm as compared to rotating their external audit firms to perform the company's external annual audit. While the modifications were as one would expect, the results were not statistically significant.

Table 3, Panel C contains the results of the t-test relative to auditor's propensity to report errors. T-test results indicate that, at 95% confidence level, there was a significant difference (p=.001) between the means responses of the NoAFR and AFR groups. Participants in the AFR group (M = 2.62, SD = 1.04) were less likely to question whether the CPA firm would ensure that material error discovered during the audit would be reported than those in the NoAFR group (M = 3.07, SD = .954). Further analyses reveal that only 23% questioned whether the auditors would ensure that a material error discovered would be reported in the AFR scenario compared to 40% in the NoAFR scenario. Loan officers viewed the NoAFR scenario differently from the AFR scenario. In other words, the reporting of material discovered errors when the same CPA firms perform the audit significantly affected the loan officers' perceptions of audit quality.

Comments -Audit Firm Rotation

Respondents were given the opportunity to provide additional comments relating to audit firm rotation for public companies. Participants made comments which tended to cluster into three areas. Table 3 contains a sample of the comments of the respondents to the open-ended section.

A closer inspection of the comments of those supporting rotation indicate that about half are skeptical that it will enhance audit quality. Notwithstanding this, they support rotation primarily on the premise that the perception of independence is important, and rotation clearly enhances the perception of independence. The other half of those supporting rotation made comments suggesting that rotation would improve audit quality beyond the appearance of independence. Comments of those not supporting rotation tended to simply dismiss rotation as unnecessary, argued that the cost would exceed the benefits or argue that safeguards can be put in place that make mandatory rotation unnecessary. Finally, participants note that the fundamental issue is whether the auditor is ethical – rotation does not address this issue.

TABLE 2
T-test Results for No Rotation versus Rotation Scenarios*

Panel A. Comparison Between Groups for Independence

Dependent Variable (Q11)	Scenario	Standard Deviations	Means **	T-test Statistic	p-value
Information in this scenario leads me to question whether the CPA firm is independent in performing	NoAFR	.964	3.07		
the audit.	AFR	1.090	2.66	-2.889	.004

Panel B. Comparison Between Groups for Discovering of Errors

Dependent Variable (Q12)	Scenario	Standard Deviations	Means	T-test Statistic	p-value
Information in this scenario leads me to question whether the auditors will actually discover material errors in the financial statements while	NoAFR	.991	3.00		
performing the audit.	AFR	1.075	2.91	-.604	.547

Panel C. Comparison Between Groups for Reporting of Errors

Dependent Variable (Q13)	Scenario	Standard Deviations	Means	T-test Statistic	p-value
Information in this scenario leads me to question whether the auditors would ensure that material errors discovered during the audit will be properly reported in the audit	NoAFR	.954	3.07		
opinion.	AFR	1.041	2.62	-3.255	.001

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TABLE 3
Respondents' Comments on Audit Firm Rotation

Panel A: Supports Rotation

Perception among the investing public and regulators is almost as important as the factual result of such rotation. Thus, I support rotation even though it is no guarantee that audit quality is improved.

My company has a long-standing internal policy of changing accounting firms every 5 years. We have benefited from new firms discovering new areas that needed attention that were overlooked by prior CPAs.

A periodic fresh look at a corporation's books and records is a good idea to portray objectivity. It may also follow that no CPA firm want to be embarrassed by a succeeding CPA firm, finding errors or improprieties. So there may be implied pressure for due diligence and more conservative practices.

There are many pros and cons based on new relationships versus old relationships and individuals involved. Ultimately, I feel rotation is a good thing.

Panel B: Do Not Support Rotation

If management's intent is not to disclose certain information to their auditors, the CPA firm will have a tough time finding it. Rotation of the CPA firm will not solve this. If management is honest, then a requirement to change firms provides no real value and just increases costs. CPA firms are not designed to be inspectors or investigators.

The quality of the auditors and partners mean more than rotation of firms.
I question if rotating audit firms every 5 years would promote more aggressive and questionable accounting practices through pressure to maintain a CPA firm client base. Companies would be forced to leave firms that are more reputable in order to comply with government regulation.

The integrity of the firm is paramount. Rotation shouldn't be mandated. A reputable firm wouldn't compromise or put itself at risk. Checks and balances should be in place where one partner would not have sole responsibility.

Audit firm rotation is very costly with no certain outcome of increased independence.

Panel C: Ethical Concerns

How does rotation stop dishonest CPAs? Does politics prevail over ethics?
SOX will help only to a degree; the fact is the company is only as strong as its weakest link. Changing individuals internally will not correct the problem if company is light on ethics.

A firm's independence is directly correlated to the companywide ethics, not rotation.

Conclusions, Limitations and Future Research

The findings in this study indicate that there is a greater perception of auditor independence and likelihood that errors discovered by the auditors will be reported when a company follows a rotation policy versus when there is no rotation policy.

The findings in this study may be of interest to board of directors and audit committees in establishing policies regarding rotating the external auditors. Since rotating appears to enhance perceptions of auditor independence, publicly traded companies that have used the same auditor for years should consider whether they should voluntarily adopt a rotation policy. A key issue that must be addressed in deciding whether to rotate auditors is whether the benefits (i.e., greater perception of independence) exceed the cost (i.e., possibly higher fees, spill-over knowledge associated with a long-term relationship).

The results of this study must be interpreted with certain limitations. First, the views are exclusively those of certified public accountants. Their views may not necessarily agree with those of other groups. Perceptions of other groups must also be considered. A second limitation is the realism of the scenario. In actual situations, bank loan officers would have had access to more information. Therefore, their decisions might have been different if additional information had been available. However, the instrument was pre-tested with doctoral students, accounting professors and local bank loan officers. All tests suggest that the instrument is clear and contain sufficient information to respond to questions.

Finally, this study adds to the body of empirical research related to perceptions of auditor independence and audit quality, however it does not address all issues. Therefore, we recommend that regulatory agencies continue to study the impact of audit firm rotation on perceptions of auditor independence and audit quality as they consider additional rules and safeguards to improve the accuracy and reliability of the financial reporting system.

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