BPM

Putting a Different Spin on Mandatory Auditor Rotation

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For years, U.S. accounting regulators and standard-setters have considered implementing mandatory auditor rotation for public companies. The rationale for such a rule is that term limits would help prevent auditors from developing long-term relationships with their clients that, proponents of rotation believe, inhibit professional skepticism.

A recent study, however, suggests that the opposite is true: Auditors are less likely to question their clients' accounting decisions if they're required to rotate periodically.

Role of professional skepticism

The Public Company Accounting Oversight Board (PCAOB) defines professional skepticism as "an attitude that includes a questioning mind and a critical assessment of audit evidence." Auditors shouldn't be satisfied with weak evidence merely because they believe management is honest, particularly in areas that involve significant management judgment or unusual transactions.

Professional skepticism also plays a critical role in an auditor's consideration of fraud. If fraud risk is high, for example, an auditor might modify planned audit procedures to gather more reliable evidence in support of financial statement assertions.

Impact of auditor rotation

Public companies in the European Union will soon be required to rotate auditor firms every 10 years (with certain exceptions). The United States doesn't impose mandatory audit firm rotation, although it does require accounting firms to rotate the engagement partner with primary responsibility for a public company's audit every five years.

In 2011, the PCAOB proposed mandatory audit firm rotation every several years, but the proposal was met with widespread opposition from auditors and public companies. It was never implemented. In 2013, the PCAOB proposed requiring public companies to disclose their audit firm's tenure, without imposing mandatory rotation. This proposal is still under review.

Big question

The continuing debate over mandatory auditor rotation raises the question: What is the actual impact of auditor rotation on auditor independence and professional skepticism? A recent study conducted by researchers at the University of Mississippi, the University of Illinois at Urbana-Champaign and the University of Massachusetts–Amherst helps answer this question.

In "The Effects of Auditor Rotation, Professional Skepticism, and Interactions with Managers on Audit Quality," published in the American Accounting Association's The Accounting Review, the researchers reveal that the benefits of professional skepticism disappear — and even reverse — when auditors rotate. "That is," the study states, "rotation and a skeptical mindset interact to the detriment of audit effort and financial reporting quality."

So why is this the case? According to the authors, knowing that the client relationship isn't long-term, rotating auditors "likely perceive themselves to be less competent in evaluating the honesty or dishonesty of the … manager relative to auditors who do not rotate." As a result, "rotating auditors would find it difficult to garner psychological support for the probability of manager dishonesty, leading them to be less likely to choose high levels of audit effort than non-rotating auditors." Interestingly enough, the negative impact of auditor rotation on accounting vigilance results from a "subtle psychological effect," rather than a conscious effort by auditors.

Weigh the pros and cons

The study's authors have urged standard setters, auditors and investors to consider the psychological effects of auditor rotation when evaluating the relative costs and benefits of auditor rotation. Similarly, public companies should consider the potential impact of auditor rotation on professional skepticism when weighing the pros and cons of changing audit firms. Without professional skepticism, the value of an audit — to your company and its stakeholders — is impaired.