

## **IMPACT OF AUDIT ROTATION ON AUDIT QUALITY: A CASE OF MASVINGO**

**Debwe Bridgette\* Mercy and Mswazi Tariro Grace\*\***

### ***Author correspondence:***

\*\*Zimbabwe Open University. MP119. Mount Pleasant. Harare. Department of Accounting and Auditing.

Email address: mbarat@zou.ac.zw

### **Abstract**

The aim of the study was to determine how audit rotation impacts on audit quality. The research objectives were to examine how audit rotation enhance audit quality in Masvingo and establish the extent to which audit rotation improve auditor independence. In carrying out the research quantitative and qualitative research methodologies were used. Questionnaires were distributed to seven audit partners and interviews were conducted with ten audit clients. Results drawn from data indicated that audit rotation enhances audit quality because audit rotation strengthen auditor independence since the auditor would be objective. The results found that objectivity of the auditor implies that his or her decisions are not influenced by the long auditor-client relationship which in turn results in a positive impact on audit quality. Research findings stated that to ensure auditor independence, the audit partners in Masvingo should be rotated after a period of ten years to give them fresh engagements. Rotation of audit partners implies that the auditors perform all necessary tests and work hard to produce a high quality audit report. It is recommended that clients have to seek non-audit services from other firms and not from audit partners who would be auditing their work to enhance auditor independence.

Key words: auditor, auditor-client relationship, auditor independence, audit rotation, audit quality,

### **1. Introduction**

Long tenure of auditors usually impact negatively on audit quality, because auditors may develop a close relationship with the management and they will lose their objectivity and independence and may not be willing to question or challenge management claims when necessary (Ouyang and Wan, 2013:23). Proponents of mandatory rotation of auditors are concerned about the risks that long-term auditor-client relationships pose to the auditor's mind set. By limiting that relationship, rotation will ostensibly improve audit quality by helping ensure that auditors remain professionally skeptical and do not become overly trusting of their clients' assertions.

Some companies raised concerns worldwide about auditor independence and audit quality. To improve audit quality, mandatory audit firm rotation was advocated in different countries. It is argued that audit quality is diminished with long audit tenure, that mandatory rotation will reduce familiarity threat, ensures auditors independence and provides a greater skepticism and a fresh perspective that may be lacking in long-standing audit or client relationship. In order to enhance the perceptions of auditor independence and the credibility of their function, regulators have established measures designed to ensure

that auditors remain independent of their audit client. These measures include rotation of audit engagement partners and mandatory audit firm rotation. This was triggered by the collapse of Enron, an energy trading company that relied on dubious accounting practices to hide poor performance to its shareholders during hard times. The accounting practices included the mark- to- market accounting which allowed the company to write unrealized future gains from some trading contracts into current income statements, thus giving the illusion of higher current profits. Another practice was to transfer troubled operations of the company to Special Purpose Entities (SPEs) so as to keep the troubled assets off Enron's books, making its losses look less severe than they really were. During its operation the firm relied on only one auditor named Arthur Andersen (Bandarenko 2009).

Cameran, Dopuch, Gietzmann and Sen, Catanach and Walker (2005) claim that the introduction of mandatory audit partner rotation is a means of strengthening independence, reducing the incidence of audit failure and improving the quality of audits. Long association with the client may increase potential threat to professional competence and due care and will resultantly leads to a negative audit quality. This is due to the fact that an overreliance on historical knowledge of the business and trust of directors could cause senior audit staff to overlook key issues. Audit rotation encourages fresh perspectives and ideas, which ensures a constantly high quality of service since information is generated from scratch rather than from knowledge of the business due to a long relationship.

In order to enhance the audit quality, different countries require companies to change their audit firms under mandatory audit firm rotation. For instance, Brazil and Italy requires its public listed companies to rotate their auditors after a period of five and nine years correspondently (Jackson, Moldrich and Roebuck, 2008:421). In Spain, from 1991-1995, audit firm rotation was required. A study was done that compared all the audits performed in that time period to all audits performed five years after firm rotation was recalled. There was a positive impact on the quality of the audits that were done during audit firm rotation as compared to audits that were done after firm rotation ended (Barbadillo, Aguilar & Carrera, 2009). This showed that audit rotation impacts positively on audit quality. South Africa has also had its fair share of corporate financial failures and scandals, perhaps most recently the demise of African Bank. Many of these failures have partly been blamed on the failure to rotate its auditors. The collapse of LeisureNet in 2000 was as a result of poor auditor behaviour stemming from a lack of independence due to long auditor to client relationships. In this regard, the Independent Regulatory Board for Auditors of South Africa announced its plans to pursue mandatory audit firm rotation for the audits of public interest entities to enhance audit quality. The motivation for this decision was firstly due to concerns raised about independence issues due to long auditor to client relationships.

In Zimbabwe, it has been observed in the recent past that the same auditing firms are auditing the same organisations for periods of more than ten years without rotating. For example, auditing firms in Masvingo town have been auditing the same companies for more than ten years. Their reason for clinging to the same companies for long periods are as a result of the current economic hardships where companies are folding up and the audit firms have to compete for the few available clients. As a result the companies have been forced to have long-term relationships of over ten years. Auditing firms in Masvingo town argue that it is better to audit the same company for over the stipulated time due to the prevailing economic hardships. It is very difficult to engage new clients due to competition for clients and the scarcity of companies in the market.

The Zimbabwean Accounting Policy on auditing ethics and Section 139 (2) of the Companies Act, 2013 has mandated all listed companies and certain categories of unlisted public companies and private companies to mandatorily rotate their auditors once their firm has served office for a period of 10 or more consecutive years. The accounting policy was introduced to maintain audit quality work because it is argued that if the same audit firms serve for more than 10 years they slowly lose their objectivity and their decisions may be influenced by the long audit to client relationship. The Companies Act also stipulate that no listed company shall appoint or re-appoint an individual as auditor for more than one term of five consecutive years. The Act was introduced to enhance audit quality because it is believed that if the auditor changes, the incoming auditor start from scratch with their client, which means no longstanding relationship is intact thereby enhancing auditor independence which leads to audit quality.

However, according to professional ethics and conduct policy, it is unethical to have a long-term auditor-client relationship of more than ten years as it tends to harm actual and perceived auditor independence and hinder fresh ideas that improve audit quality. Report on the observance of standards and codes (ROSC) Auditing and Accounting Zimbabwe (2011) highlighted that Audit firm rotations are mostly taking place in bank audits at the insistence of the Reserve Bank of Zimbabwe. The insistence was done after the collapse of financial institutions like Interfin bank, Trust bank, CFX bank and others due to auditors who failed to report the shenanigans they would have seen in their client's banks during audits because of long tenure with their clients. Audit rotation has resulted in the enhancement of audit quality in banks. However, there are some locally listed companies in Zimbabwe that have been audited by the same audit firm for over 30 years and companies in Masvingo have also not been spared. Some stakeholders expressed concern over close relationships between some companies and their auditors in different forms that compromise auditor independence (ROSC A&A, 2011) Many believe that the longer the audit tenure, the lower the audit quality due to the closer relationship between auditors and management (Chaney & Philipich, 2002; Firth, Rui & Wu, 2010). This closer relationship creates more flexibility for the management to produce financial statements in the auditor's favour (Davis, Soo, & Trompeter, 2002). It is against this background that this study seeks to investigate the impact of audit rotation on audit quality in organisations and establish the extent to which audit rotation improve auditor independence in Masvingo.

## **2 Research method**

The study employed a cross sectional descriptive survey design in which data is collected from a population at one specific time (Gray, 2009:575). The researchers chose the cross-sectional descriptive survey in this study for example they are inexpensive and allow the researchers to collect a great deal of information quite quickly. This study focused on the perceptions on non-audit rotation's impact on audit quality in Masvingo. Thus, all the Accounting Services Firms in Masvingo became the target population, but it was not feasible to carry out a study which covers such a larger population. For the purpose of feasibility the researchers chose to work with Chartered Accounting Firms namely AMG and TAM and their clients in Masvingo only. The researchers used purposive sampling in selecting the firms which were used in the study. As such 2 firms were selected. From the 2 firms the researchers used convenience sampling to select the audit partners which were used in the study. Therefore, a total of seven partners were selected. The researchers then used simple random sampling to select clients from the firms. Thus, a total of ten

clients. This sampling technique was used on the Audit Firms (AMG Chartered Accountants and TAM Chartered Accountants of Zimbabwe), because they are the only two Chartered Accounting Firms doing audits in Masvingo, the researchers hand-picked them deliberately/purposively in order to work with them in this study. Data from the clients was collected using interviews and data from the audit partners was collected using questionnaires. In this study, the 10 clients responded to the interview. This study employed a closed ended itemised questions which were derived from the research questions to form a structured questionnaire. In this, case 7 questionnaires were distributed to the clients.

The researcher observed ethical principles like informed consent, privacy, non-maleficence (need to do no harm), beneficence (need to do good), right to anonymity and confidentiality. Informed consent means participants should understand that they are taking part in research and what the research requires of them. The researchers allowed the participants freedom to choose to participate or to withdraw during the course of the research. Qualitative data was analysed using thematic approach and quantitative data was analysed using Statistical software to produce graphs and tables.

### 3. Results and analysis

Results of the study are presented following the two objectives which were formulated earlier on. Results presented in Table 1 show effects of audit rotation on audit quality.

#### 3.1 Effects of audit rotation on audit quality

Findings in Table 1 show that all the audit partners and more clients either strongly agreed or agreed that audit rotation enhances audit quality. Results from the clients show that most of the clients agree that audit rotation affects audit quality. However, it was also noted that few respondents disagreed with the view that audit rotation affected audit quality. This shows that a total of 82% of the respondents agreed that audit rotation enhances audit quality whilst 18% disagreed. From the above results it can be argued that audit rotation enhances audit quality.

Table 1 Effects of audit Rotation on audit quality

Respondent	Strongly agree	Agree	Neutral	Disagree	Strongly disagree	Total	%
Audit Partners	5	2	0	0	0	7	41
Clients	4	3	0	2	1	10	58
<b>Total</b>	<b>9</b>	<b>5</b>	<b>0</b>	<b>2</b>	<b>1</b>	<b>17</b>	<b>100</b>

Results of this study showed that both audit partners and clients agree that audit rotation enhances audit quality. These findings are in line with Zawawi (2007), who indicated that the concept of mandatory audit rotation was introduced as a result of the highly publicized corporate failures that resulted in litigations and low quality work by audit firms. Mandatory rotation is viewed as improving auditor independence both in fact, relating to the auditor's independent, mental attitude, and in appearance to, relating to others' perceptions of auditor independence, which in turn results in a positive impact on audit quality (Daugherty, (2013). Mandatory auditor rotation has frequently been suggested as a means of strengthening independence and reducing the incidents of audit failure (Catanach and Walker, 2010). It is argued that the length of the auditor-client relationship constitutes a major issue in the auditor conflict of interest, because long auditor-client relationships may cause auditor complacency about management decisions regarding the firm's financial

statements. Following this view, mandatory rotation of external auditors has been suggested. In a similar way, it was suggested that long auditor tenure is not desirable because it gives the audit firm time to develop a close relationship with the auditee' (Whittington, 2005: 177). Thus, the auditor's incentive to preserve independence declines over time. Resultantly audit quality is compromised.

Catanach and Walker (1999) state that charging the auditor is an instrument used to reinforce the auditor's independence and improve the audit quality. Audit rotation is suggested as a means of improving audit quality through maintained independence and new "fresh eyes" on audits. This enhances audit quality.

### 3.1.1 Audit Partners- Clients assessment of confidence with impact of audit rotation on audit quality.

The results presented in table 2 show audit Partners- Clients assessment of confidence with impact of audit rotation on audit quality. From the table 2 it can be noted that all audit partners (100%) are either very confident or confident with the impact of audit rotation on audit quality.

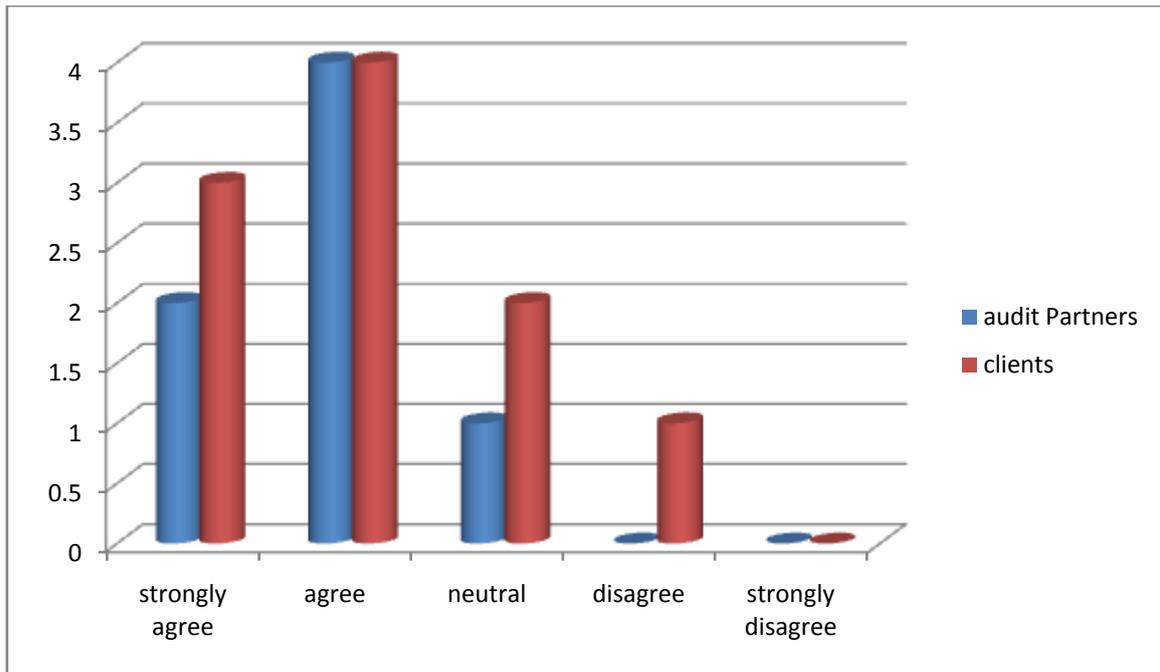
Table 2 Audit Partners- Clients assessment of confidence with impact of audit rotation on audit quality

<b>Respondent</b>	<b>Very Confident</b>	<b>Confident</b>	<b>Not confident</b>	<b>Not very confident</b>	<b>Total</b>
Audit Partners	5	2	0	0	7
Clients	7	1	1	1	10
<b>TOTAL</b>	<b>12</b>	<b>3</b>	<b>1</b>	<b>1</b>	<b>17</b>

Results from the findings on clients reveals that 80% of the respondents were either very confident or confident with the impact of audit rotation on audit quality leaving a 20% of the respondents who were not confident in relation to the subject matter. Those who supported audit rotation argued that new auditors normally have a questioning mind that brings a "fresh look" to detect problems in a client's financial reports, audit rotation may improve audit quality as provided for by Lu and Sivaramakrishnan, 2009). Those who were against audit rotation argued that it takes years for new auditors to get familiar with the client's business and accounting practices, thus audit quality may suffer from audit rotation.

### 3.2 Response on the effects of audit rotation on auditor independence

Seven audit partners and ten clients were asked about the effects of audit rotation on auditor independence and their responses are indicated by the histogram below:



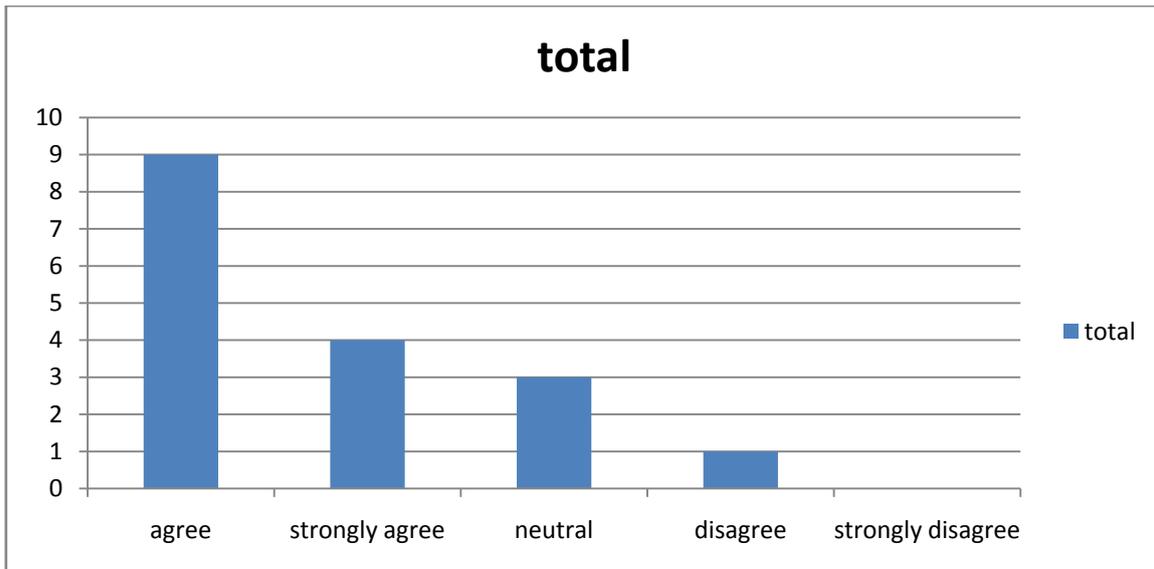
**Figure 1: Effects of audit rotation on auditor independence**

The above histogram shows the opinions of the respondents on whether audit rotation enhances auditor independence. Those who agreed that audit rotation enhances auditor independence constituted 76% of the respondents, 18% were neutral and 6% disagreed that audit rotation enhances audit independence.

Results of the study show that most of the respondents agree with the view that audit rotation has an effect on auditor independence. The results are supported by Daugherty, (2013) who indicated that mandatory rotation, improves auditor independence both in fact, relating to the auditor's independent, mental attitude, and in appearance to, relating to others' perceptions of auditor independence, which in turn results in a positive impact on audit quality. The findings are further supported by Catanach and Walker, (2010), who stated that mandatory auditor rotation has frequently been suggested as a means of strengthening independence and reducing the incidents of audit failure. In a similar way, it was suggested that long auditor tenure is not desirable because it gives the audit firm time to develop a close relationship with the auditee' (Whittington, 2005: 177). Thus, the auditor's incentive to preserve independence declines over time which resultantly audit quality is compromised.

### 3.2.1 Level at which Audit Rotation improves Auditor Independence

Audit partners and clients under investigation were asked about the level at which audit rotation improves auditor independence. The levels for rating was as follows ranged from levels - 5 Lowest to 1 Highest. The responses are presented in Figure 2.



**Figure 2: Level at which audit rotation improves audit quality**

The findings from the research in the bar graph above was a rating in terms of the levels at which audit rotation improves auditor independence ranging from the highest level 1 up to the lowest level 5. Thus, 9 respondents from both audit partners and clients were rated first as agreed respondents. Those respondents who strongly agreed that audit rotation improves auditor independence were rated second with a minimum number of 4 respondents. The findings also reveal that 3 participants from the research neither agrees nor disagree that audit rotation improves auditor independence. However, only 1 respondent from clients disagreed that audit rotation improves auditor independence while none of the groups of respondents strongly disagreed with the above view in question.

Most audit firms in Masvingo are auditing the same organisations for more than 10 years. According to Chan et al (2014), audit rotation is a specified time that an audit firm is given by policy to audit a firm. After such period another firm/auditor should come in despite the efficiency, quality, and independence of the audit firm, the willingness of the shareholders and the management to keep the audit firm.

#### 4. Conclusions

The main purpose of the study was to establish the perceptions on non-audit rotation's impact on audit quality. Results drawn from data proves that audit rotation enhances audit quality because audit rotation strengthen auditor independence since the auditor would be objective and his or her decisions may not be influenced by the long auditor-client relationship which in turn results in a positive impact on audit quality. Auditing firms in Masvingo town have been auditing the same companies for more than ten years in violation of policies and this has resulted in negative audit quality since long auditor-client relationships reduces auditor independence. Audit rotation cycle in Masvingo can highly be improved by ensuring that firms adhere to the policies, rules and regulations pertaining to auditor- client relationship. Based in the findings the study recommends that the firm must put in place necessary controls and review functions to monitor audit engagements in order to improve audit quality. The firm must also consider rotating key partners of audit engagement in order to improve audit independence. It can be further recommended that firms should restrict provision of non-audit services since this forms a bond between the audit firm and client hence reduces audit independence which results in adverse audit quality.

## References

- Barbadillo, E. and Aguilar, N. Does Auditor Tenure Improve Audit Quality? *Mandatory Auditors Rotation versus Long-term Auditing*. An Empirical Analysis .Working Paper, University of Cadizi, Spain.2008
- Cameran, J., Vincenzo,D.D. and Merlotti,E. “The Audit Firm Rotation Rule: A Review of the Literature”, [working paper] SDA Bocchini, School of Management, Milan.2005
- Catanch, A. and Walker, P.I. “International Debate Over Mandatory Auditor Rotation: A Conceptual Research Framework”. *Journal of International Accounting, Auditing,Taxation*, 8.1999
- Chan,K.C., Farrell, B. and Healy, P. “Audit Firm Rotation- Concerns and Considerations. *The Journal of Applied Business Research –Jan/Feb 2014 Vol.3,No.1*.2014
- Chaney &Philipich Shredded reputation: the cost of Audit Failure.*Journal of Accounting Research* 40(4):1221 – 1245. 2002
- Daughterty, B. E., Dickins,D., Hatfield,R.C. and Higgs,J.L Mandatory Audit Partner Rotation: *Perceptions of Audit Quality Consequences*. Current Issues in Auditing Vol.7,Issue 1. American Accounting Association. D01:10.2308/ ciia-50446.2013
- Davis, L. R., Ricchiute, D. N., &Trompeter, G. . Audit effort, audit fees, and the provision of non-audit services to audit clients. *The Accounting Review*, 68.1993
- Gray, D.E. .*Doing Research in Real World*. Los Angeles: SAGE.2009
- Jackson, B.A., Moldrich, M. and Roebuck, A. “Mandatory Audit Firm Rotation and Audit Quality”. *Journal of Managerial Auditing*,23, 420-437.2008
- Lu, T., &Sivaramakrishnan, K. Mandatory audit firm rotation: Fresh look versus poor knowledge. *Journal of Accounting and Public Policy*, 28.2009
- Ouyang, B. and Wan, H “Does Audit Tenure Impair Auditor Independence? Evidence from Option Back dating scandals”. *International Journal of Business and Social Science Vol.4,No.14:Nov 2013*.
- Rui, and Donghui Wu Do Social Ties between External Auditors and Audit Committee Members Affect Audit Quality?. *The Accounting Review*: September 2017, Vol. 92, No. 5, pp. 61-87 2010
- Siregar, V.S.,Amanillar,F., K. Evidence on the joint determination of audit and non-audit fees. *Journal of Accounting Research*, 41.2003
- Whittington & Pong. The determinants of audit fees: some empirical models. *Journal of Business Finance and Accounting*. 2005

Zawawi, M.B.M., Audit Firm Tenure and Financial Reporting Quality in Malaysia. M.Sc Thesis, Department of Economics and Management Sciences, International Islamic University Malaysia. 2007