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Audit Rotation and Strength of Corporate Governance and its Effects on Audit Quality

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ABSTRACT

This paper discusses the effects of audit rotation - audit partner rotation and audit firm rotation, and strengths of corporate governance on audit quality. A total of 130 audit practitioners participated in the experimental study. The results showed that audit firm rotation had a significant effect on audit quality while both audit partner rotation and strength of corporate governance had no significant effect on audit quality. Further, evidence showed absence of interaction effects between audit rotation and strength of corporate governance on audit quality. The findings suggest the importance of enhancing audit quality through the practice of rotating audit firms but not audit partner. This study provides additional recent evidence concerning the effects of audit partner rotation and audit firm rotation, and strengths of corporate governance on audit quality in the Malaysian setting. Thus, policy makers should revisit whether the current policy of audit firm rotation and effectiveness of corporate governance best practices is sufficient in ensuring high audit quality performance.

Keywords: Audit Rotation, Partner Rotation, Corporate Governance, Audit Quality

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INTRODUCTION

Corporate failures have reopened debate concerning issues of auditors' independence, audit tenure, audit quality (AQ) and corporate governance (CG) practices. The literature suggest that auditors' independence and audit tenure may affect AQ (Khaksar et al., 2022). Long audit tenure may lower AQ due to the inability of the auditors to maintain his/her independence and/or maintain 'critical mind'. Consequently, auditors may not be able to detect and/or report misstatements. Jurisdictions like the United Kingdom and Austria require both the AFR and the APR as mechanisms to ensure auditors' independence and enhances AQ (European Directive, 2014). Whereas, in Malaysia, the Malaysia Institute of Accountants (MIA) requires the APR as an additional mechanism to enhance AQ but opted not to prescribe the AFR (MIA, 2018).

Correspondingly, regulators around the globe have strengthened CG practices that include reaffirming the roles, functions, activities, composition and resources of board of directors (BOD) and its sub-boards such as the audit committee (AC). The numbers of BOD members must be adequate that comprises of independent members and meets frequently as prescribed by the Malaysia Code of Corporate Governance (MCCG) (2021) to ensure its effectiveness (Securities Commission Malaysia, 2021). Similarly, the oversight roles of external audit performed by the AC has been strengthened with the aim to enhance AQ (Herranz et al., 2020; Sulaiman & Yasin, 2021). Prior research has reported a positive relationship between CG practices quality, audit rotation and AQ (eg. Cimini et al., 2020). However, research simultaneously examining the effect of audit rotation and strength of CG on AQ is scant.

The objective of this study was to examine the effect of audit rotation (APR and AFR) and the strength of CG on AQ. The contributions of this study are three fold. First, it contributes to the literature by assessing both the effects of audit firms and APR on AQ. This study is significant given that many jurisdictions around the globe currently prescribe audit firms and APR. In addition, a large number of jurisdictions call for the AFR even though it has been strongly opposed. Thus, the extent to which the AFR gives effect to AQ warrants further assessment. Secondly, this study also examined the CG effect on AQ. Hence, the extent to which reforms in the CG give effect to AQ needs further evaluation. Finally, this study investigated the possible interaction effects of audit rotation and strength of the CG on AQ. The next section provides the study's background, followed by theoretical underpinnings and hypotheses development sections. Subsequently, the research methodology section and conclusions are presented.

BACKGROUND

In line with the global development in various jurisdictions such as the European Union (European Directive, 2014) and the US (SOX, 2012) on audit rotation, the MIA has issued Circular No. MF6/2018 and MF7/2018 that prescribed APR of seven (7) years and cooling-off of five (5) in Malaysia (MIA, 2018). The MIA By-Laws on Professional Ethics discusses observance of partner rotation due to potential familiarity and self-interest threats because of a long association with a particular audit client. This resolution can be seen as one of the mechanisms that can improve AQ (Sulitso et al., 2019).

Weak CG and low AQ have been cited as one of the causes of business and audit failures (such as Enron and 1MDB). Thus, within the Malaysian setting, the recent MCCG emphasized the importance roles of key governance mechanisms including the BOD, AC, external auditors (EA) and internal auditors in ensuring high financial reporting quality and AQ (Securities Commission Malaysia, 2021). In particular, the code emphasizing the effective features of the main board and its sub-boards; composition, independence, financial literacy and activities for strong CG practices. Likewise, AC is responsible to overseeing AQ by examining matters such as audit fees, provision of non-audit services and tenure related to auditors' independence that could affect AQ.

THEORY AND HYPOTHESES DEVELOPMENT

Agency Theory

An agency relationship is a contract in which the principal (shareholder) authorizes the agent (management of the entity) to execute management tasks for the principal's benefits (Jensen & Meckling, 1976). Nevertheless, agency conflicts arise when the agent is viewed to maximise their own wealth at the expense of the principal. One strategy to resolve the agency conflict is through the practice sound CG principles (e.g. Ali et al., 2019). Corporations that embrace good CG practices ensure that an adequate system exists to direct and control the business affairs (Alawaqleh et al, 2021). For instance, the roles of the BOD and its sub-boards are important in monitoring the principal actions whilst ensuring that an appropriate governance structure is in place.

Likewise, in the contracting relationship, an independent audit is used to reduce the information asymmetry between the principal and the agent. Accordingly, auditors' roles would be able to align the interests of agents and principals that allow principals to assess their agents' actions and build trust in them. However, lack of auditors' objectivity and independence has been cited to cause lack of confidence on the principal on reported business performance by the agents (Emmanuel & Uzoka, 2022). In this context, there are instances in which auditors failed to discharge their duties (issuing an accurate independent audit opinion) that has contributed to a series of audit and business failures. In consequence, AQ has been questioned in this regard. To address this issue, requirements for audit rotation has been made by various regulators in different jurisdictions (Anggraini et al., 2022).

Hypotheses Development

Two competing views exist about the impact of audit tenure on AQ. First, long audit tenure is related to high AQ through the auditors' enhanced ability to detect misstatements resulting from greater understanding of the client's business and processes (Amerongen et al., 2022; Khaksar et al., 2022). Longer audit tenure would increase AQ because of the increased knowledge of audit clients that are negatively related to low AQ (financial restatements or earnings management) (Simamora & Hendarjatno, 2019).

Second, long tenure could reduce AQ due to less rigorous audit procedures that reduce auditors' capacity to detect misstatements, (Harber & Maroun, 2020; Liu et al., 2021), impair auditor independence and decreased attentiveness due to familiarity threats (Wilson et al., 2018), incomprehensive audit programm (Corbella et al., 2015), and reduced propensity to issue an accurate audit opinion and decrease accounting conservatism (eg. Dogson et al., 2020).

Overall, inconclusive findings are found pertaining to the impact of the AFR and APR on AQ. Kalanjati et al. (2019) found that the APR enhances AQ. Similarly, Lu and Sivaramakrishnan (2009) reported that the AFR provides a "fresh look" for successor auditor which has reduced auditor's bias and improved investment efficiency and client's trust. Likewise, Blandon and Bosh (2013) showed that audit firm tenure is associated with low AQ – likelihood of audit qualification decreased over time. In contrast, some prior research has documented a negative relationship between audit firm and auditors' tenure and AQ (Stanley & Todd, 2007; Knechel & Vabstralen, 2007). Consistent with the theoretical underpinning and previous research, this study hypothesised:

H1a: There is a positive relationship between AFR and AQ.
H1b: There is a positive relationship between APR and AQ.

The literature suggests that good CG has a significant positive effect on AQ (Wahyudi, 2022). An independent non-executive director is a monitoring device on executive directors that enhances effective oversight on financial reporting through the board's monitoring and controlling the incongruous behaviour of executives (Amah & Ekwe, 2021; Alkdai & Hanefah, 2012). Conversely, CEO duality may affect board's effectiveness because he/she has much power and can manipulate earnings easily (Alves, 2021). A larger board size is expected to provide more supervision and monitoring by the senior management, and effectively contribute to the growth of a firm and maximisation of shareholder wealth (Erasmus, 2022).

AC is one of the key CG mechanisms in ensuring high AQ. A large AC has more resources (people and budget) that may enhance AQ (Salawu et. Al., 2018) and issues are more likely to be uncovered and resolved with a larger AC (Mohammed-Nor et al., 2010). Moreover, in terms of competency, AC members with greater experience and industry expertise can easily discover any improper practices than members with less experience (Tanyi & Smith, 2015) and enable them to better understand the company's operation and financial circumstances, and subsequently be able to provide a better monitoring role (Alhababsah & Yekini, 2021). The agency theory proposes that AC independence mitigates agency costs (Haruna et al., 2022) as AC independence and monitoring roles improves effective supervision of management activities towards financial reporting (Adhikary & Mitra, 2016; Alkebsee et al., 2022). High AQ is linked to routine meetings of the AC (Khudhair et al., 2019; Gresia & Itan, 2022; DeZoort et al., 2002) and its diligence (Xie et al*., 2003). Meanwhile, Cimini et al., (2020) reported that regardless of the AFR or APR rotation, investors consider accounting figures more valuable in the subsequent year. In addition, Jennings et al., (2006) empirically report that s*trengthening CG and rotating audit firms (compared to partner rotation) leads to enhanced auditor independence perceptions.

In line with the propositions of the agency theory and the existing literature, this study proposed that audit firm/audit partner rotation, together with a strong CG, can enhance AQ. Accordingly, this study posited the following hypotheses:

H2: There is a positive relationship between the strength of CG and AQ
H3a: There is an interaction effect between AFR and strength of CG on AQ.
H3b: There is an interaction effect between APR and strength of CG on AQ.

RESEARCH METHODOLOGY

Research Design and Instrument

This study adopted a 2x2 factorial experimental design and had two independent variables, i.e., audit rotation (APR/AFR) and strength of CG, with two treatments (strong) and (weak). The case material utilised in this study was adopted from past research: Zimbelman (1996), Brief et al. (1996), and Moet (1997). Eight versions of the case study were developed for XYZ Manufacturing Bhd. A company in the manufacturing industry was assumed because the manufacturing industry ranked among the highest in committing fraud (Baglia, 2000).

The eight versions of the case materials were classified into 2 groups: 4 (AFR) and 4 (APR) with weak or strong CG. In order to create the scenarios, each version of the case materials contained these information: (i) policy on audit rotation: whether the company had a policy to rotate the auditor partner/audit firm or not; and (ii) CG practices: whether appropriate CG in accordance to the MCCG was practiced by the company or not. The case material has 2 parts.

Part A comprised of the following information and tasks: i) an audit planning phase where background information of XYZ Manufacturing Bhd. including its audit rotation policy and CG, ii) a scenario where the year-end audit has been completed. The subjects were assumed to have conducted the audit of the sales and collection cycle and audit evidence accumulated to this audit were provided, iii) to provide their judgment about the likelihood that the management of XYZ Manufacturing Bhd. would fraudulently misrepresent financial statements, iv) to determine whether the amount in the two accounts in the sales and collection cycle of the company contained material misstatement/s or not, and part B: demographic information of the respondents.

Sample and Administration of the Research Instrument

The sample group of this study was audit practitioners, designated as audit partners or audit managers. The audit partners were selected as they are the engagement partners for an audit while the audit managers were selected as in most audit engagements, they were the personnel "in-charge" of the audit work. A total of 300 questionnaires were distributed in 10 MIA training attended by the audit practitioners. In the end, a total of 130 questionnaires were collected with a response rate of 43%. The cover letter accompanying the research instruments stated clearly that the instruments had to be attempted by the audit partner or audit manager. The research instruments were pre-tested with five panel of established researchers, to evaluate clarity and quality of its contents. Upon amendment, the research instruments were sent for pilot testing to 30 audit managers. The results from the pilot testing validated the research instruments that were then used for the main study.

Variables and Analysis of the Study

Consistent with Moet (1997) the dependent variable was the AQ which was measured by the EAs' ability to detect the likelihood of fraud. AQ encompasses of the auditor's ability to detect and report any material errors (DeAngelo, 1981). It was measured on a 7-point Likert scale ranging from extremely unlikely to extremely likely, by asking the subjects: "Based on your judgment, what is the likelihood that the management of XYZ Manufacturing Bhd. would fraudulently misrepresent financial statements?

(Question 1 in Part A). An answer "likely" and above indicated that the management fraud would have been detected. Similar to Bernardi (1994), Question 2 of Part A asked the subjects' judgment about which account/s they think were not fairly stated. If the EA answers "No" (the account was not stated fairly), and the fraud was considered to have been detected." The results may offer consistency to Question 1.

There two independent variables in this study that were: strength of CG and the existence of partner/AFR. The strength of CG was operationalised through the inclusion of information about the CG practices (including and composition of the BOD, and number of meetings, composition and financial literacy of the AC). To examine the relationships between the variables the control variable in this study was auditor's experience. Prior research has found that the auditor's experience may have a significant effect on the ability to detect errors and material misstatements and has positive effects on AQ (Ocak & Can, 2019; Liu & Zhu, 2021). General linear model univariate analysis for between-subjects was used because of the factorial experimental approach adopted by this study. The analysis was done separately for the data from the AFR group and APR scenarios.

FINDINGS AND DISCUSSION

Demographic Profile and Response Rate

A total of 117 (90%) of the respondents were attached to non-big four audit firms and 13 (10%) are from the big four audit firms. The majority of the subjects, 116 (89.2%), were audit managers whereas only 14 (10.8%) were audit partners. Additionally, a majority of the subjects, 66 (50.8%) have been in the current position for less than 5 years and 20 (15.4%) had more than 10 years auditing experience. Furthermore, the majority of the subjects, 61 (46.9%) possessed an ACCA as their professional qualification. 13 (10%) had CPA (Australia) qualification, 7 (5.4%) had MICPA qualification, 9 (11.3%) had CIMA qualification while 44 (33.8%) indicated other qualifications.

The subjects were asked whether they had ever worked on an audit client where fraudulent financial reporting of material in nature was detected. About 108 (83.1%) of the subjects had never experienced detecting fraud while conducting an audit. Nieschwietz et al. (2000) indicated that experiences with fraud in audit engagements were rare, so for any single auditor, repeated practice in detecting that it was also rare. Only 51 (39.2%) of the subjects had participated in training related to fraud detection issues while a majority of them 79 (60.8%) had never attended it. A total of 130 responses were gathered in this study - 61 (AFR) and 69 (APR), respectively.

At the end, the response rate for the subjects per cells consisted of: 1) audit firm was not rotated – CG was weak (21) and CG was strong (11), and audit firm rotated - CG was weak (13) and CG was strong (24), 2) audit partner was not rotated – CG was weak (15) and CG was strong (11), and audit partner rotated - CG was weak (15) and CG was strong (20), 2).

Audit firm rotation scenario

The results showed that there was a significant main effect of AFR, (3,3.637), $p = .061$, on the AQ (see Table 1). This revealed that the mean of the AQ (which is represented by the ability to detect the likelihood of fraud) was different between those EA whose auditee had a policy of rotating the audit firm and those whose auditee had no policy of rotating the audit firm. Furthermore, the results showed that there was no significant main effect of strength of CG, (1,0.004), $p = .952$ on AQ. This indicated that the mean of the AQ was not different between those EA whose auditee had a strong CG and those whose auditee had a weak CG.

In addition, there was no interaction effect, (1, 0.130), $p = .719$, between AFR and the strength of CG on the AQ. Thus, this study concluded that under the AFR scenario, the results supported $H1_a$ which confirmed that the AFR was positively related to the AQ. However, this study concluded that under the AFR scenario H2 is rejected because the AFR was not related to the AQ. Moreover, this study concluded that $H3_a$ was rejected as there was no interaction effect between AFR and the strength of CG on AQ.

Table 1: Tests of Between-Subjects Effects (Audit Firm Rotation Scenario)

Source	Type III Sum of Squares	df	Mean Square	F	Sig.
Corrected Model	4.847[a]	3	1.616	1.352	.265
Intercept	1697.358	1	1697.358	1419.863	.000
Audit firm rotation	4.348	1	4.348	3.637	.061*
Strength of CG	.004	1	.004	.004	.952
Audit firm rotation * Strength of CG	.156	1	.156	.130	.719
Error	77.703	65	1.195		
Total	1940.000	69			
Corrected Total	82.551	68			

Note: a. R Squared = .059 (Adjusted R Squared = .015), * Significance level = 10%, Dependent Variable: AQ

Audit partner rotation scenario

The results showed that there were no significant main effects of APR, (1, 0.083), *p* = .774, and strength of CG, (1, 0.186), *p* = .668, on the AQ (see Table 2). This denoted that the mean of the AQ (which is represented by the ability to detect the likelihood of fraud) was not different between those EA whose auditee had a policy of rotating the audit partner and those whose auditee had no policy of rotating the audit partner. Also, the result signified that the mean of the AQ was not different between those EA whose auditee had a strong CG and those whose auditee had a weak CG. In addition, the results showed no interaction effect, (1, 1.039), *p* = .312, between APR and strength of CG on the AQ. Thus, this study concluded that under the APR scenario, the results rejected $H1_b$ because the APR was not related to AQ. In addition, H2 under the APR scenario was also rejected because the strength of CG was not related to quality. Finally, $H3_b$ was rejected as there was no interaction effect between APR and the strength of CG on the AQ.

Table 2: Tests of Between-Subjects Effects (Audit Partner Rotation Scenario)

Source	Type III Sum of Squares	df	Mean Square	F	Sig.
Corrected Model	1.184[a]	3	.395	.416	.742
Intercept	1757.334	1	1757.334	1853.975	.000
Audit partner rotation	.079	1	.079	.083	.774
Strength of CG	.176	1	.176	.186	.668
Audit partner rotation * Strength of CG	.985	1	.985	1.039	.312
Error	54.029	57	.948		
Total	1884.000	61			
Corrected Total	55.213	60			

Note: a. R Squared = .021 (Adjusted R Squared = -.030), Significance level = 10%, Dependent Variable: AQ

Discussion

Despite the increased pressure to improve AQ, very limited research was performed to investigate the impact of audit firm and APR, and the strength of CG on the AQ. This study revealed mixed results concerning the effect of audit firm and APR and the strength of CG on the AQ. In an AFR scenario, $H1_a$ on the audit firm is rotated was supported. This result showed that a policy to rotate the audit firm can enhance the AQ. This finding corroborated the study by Arel et al. (2006) who found that AFR can enhance AQ. Moreover, Rickett et al. (2016) advocated that long audit tenure affected accounting quality. Thus, this study posited that when the EA suspects fraud had occurred in the financial statement based on the fraud risk indicators, the assessed fraud risk does serve as a guide to help to identify the high-risk area, for instance, an account that is possibly materially misstated.

However, in an APR scenario, H1b was not supported. The results showed that regardless of whether the policy to rotate the audit partner existed or not, there will be no impact on the AQ. This finding does not corroborate with the study by Bandyopadhyay et al. (2014) and Kalanjati et al. (2019) who found a positive association between APR and AQ. Furthermore, the finding was not consistent with Simamora and Hendarjatno (2019) who discovered that longer audit tenure would increase AQ because of the increased knowledge of specific audit clients. Nonetheless, the findings were consistent with Blandón et al. (2013) who showed that long tenure did not reduce the likelihood of qualified audit opinions.

This study concluded that a majority of the subjects 104 (57 %) had been more than 5 years in the current position either as audit partner or audit manager, hence based on their wide experience regardless of whether audit partner is rotated or not they are still able to maintain a high AQ. Similarly, H2 was not supported which demonstrated that regardless of the strength of the audit client CG high AQ can still be achieved. The finding did not corroborate with past studies such as Abbott et al. *(2004). The* $H3_a$ and $H3_b$ were also not supported, which means that the AQ does not depend on the audit firm/APR and strength of CG.

CONCLUSION

Generally, it is widely known from previous research that the role of the EA is inevitable for good CG practices. This is due to the roles of EA in providing independent assurance on true and fair views of financial statements. However, in recent years due to a number of audit failures and business collapses, the independent role of the EA and its audit service quality is deteriorating. This is due to unethical practices among the EA that jeopardised their professional objectivity, independence and integrity. Such action has affected public confidence on AQ. This study investigated whether AFR and APR affect AQ. The findings revealed a positive effect of AFR on AQ, but no significant effect found between APR and AQ. Regardless of the existence of APR, this study suggests that AQ suffers when the audit tenure is too long. This long association may impair auditor's independence and auditor scepticism that leads to lower AQ. In addition, this study found that CG elements did not significantly improve AQ.

This study offers several contributions. First, the results could be used by regulators to set up policies requiring AFR. Second, this study provides empirical evidence regarding audit firm and APR, particularly in the Malaysian setting. This study shows that AFR is an effective mechanism to enhance AQ. Second, this study reports that a long association between audit practitioners and senior executives will impair AQ. Therefore, this study provides insights for future studies to further explore potential costs and benefits, if the AFR is mandated by regulations. Third, guideline related to CG practices can be further strengthened by examining the actual impact of CG practices on auditors' performance.

A few limitations of the study are noted. First, the limitation of sample size has restricted the ability to further test audit rotation issues related to audit firm attributes. Further studies could explore the impact of rotation based on audit firm size (big, medium and small size of audit firm) and industry specialization. Second, testing of the auditor's competency, knowledge and expertise has not been conducted, which could add to a better understanding the effects of auditors' attributes on rotation issues and AQ. Third, adopting alternative measures for AQ such as types of audit reports and/or quality of disclosure of key audit matters could provide an opportunity for future research.

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