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Last year, in a pointed footnote to the scandal enveloping Wells Fargo, two major pension funds opposed ratification of the company's external auditor and called on Wells Fargo to explore changing audit firms. Yet, the company's relationship with the auditor, of 85 years' duration, continues today despite the objections of the two

large shareholders, not to mention protests from two U.S. Senators at the audit-

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mandate is a provision of the Sarbanes-Oxley act of 2002 (SOX), while the E.U. requirement dates from 2014.

How effective are these mandates in fostering high-quality audits that investors can count on? Both fall short in critical ways, concludes a scholarly paper in the March issue of *The Accounting Review*, a peer-reviewed journal of the **American Accounting Association**.

The study, by Zvi Singer of HEC Montreal and Jing Zhang of the University of Alabama in Huntsville, casts doubt that audit-partner rotation, as mandated by SOX, is a sufficient substitute for audit-firm rotation. "Overall, the results indicate that SOX did not eliminate the negative effect of long auditor tenure on audit quality," the professors conclude.

As for the E.U.'s mandate that companies seek offers from other accounting firms after 10 years of auditor tenure, the new study finds that 10 years is about the point where the ill effects of long tenure recede. As the professors explain, "Beyond 10 years of auditor tenure, the association between auditor tenure and misstatement duration is insignificant... The benefits of a fresh look exist only in the first 10 years of the auditor-client relationship."

In reaching these conclusions, the study arrives at a more skeptical view of lengthy auditor tenure than generally prevails in the scholarly literature or among key players in the investment world, who reward lengthy auditor tenure with lowered corporate borrowing costs, enhanced responses to earnings reports, and boosts in stock ratings. "The common conclusion of prior studies," Profs. Singer and Zhang write, "is that short auditor tenure leads to low financial-reporting quality because the new auditor lacks the client-specific knowledge accumulated over time. However, an alternative interpretation is that low financial-reporting quality leads to short

auditor tenure...because the auditor and the client are more likely to run into

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the subsequent annual financial report, suggesting laudable auditor vigilance and high audit quality; in the remaining instances, misstatements occurred in one, two, or more annual reports that auditors signed off on, with longer duration signaling lesser auditor vigilance and lower audit quality.

The heart of the study is analysis of the relationship between auditor tenure (number of years from hiring date to misreporting) and misstatement duration (how many misstated annual reports the auditor signed before the client issued a restatement). There was, the professors write, “a positive association...In other words, auditors with shorter tenures are faster to discover financial misreporting.” For example, when auditor tenure was three years or less, the average misstatement duration was a little less than a year, whereas when it was 11 or more years, average duration was about a year and a half, more than 50% greater.

To corroborate these findings, Singer and Zhang ingeniously take advantage of a natural experiment in which a select group of companies was forced to change an external auditor, as happened with the downfall in 2002 of the major accounting firm Arthur Andersen. Investigating Andersen clients' financial reporting in the years preceding and following the accounting firm's collapse, the professors focus on accounting misstatements that started under Andersen and ended after the forced switch to another auditor. Comparing the duration of those misstatements with those of companies that retained a single Big-4 auditor over that same span, the professors find that the latter lasted on average 15% longer, a statistically significant difference that leads them to cite this as further evidence of the salutary effect in auditing of a fresh view.

It is by applying their novel research methods to assess the U.S. and E.U. current rotation requirements that the professors discover the mandates' serious shortcomings. Since their data extends from before Sarbanes-Oxley to well after its

passage, they are able to gauge SOX's effect on the relationship between auditor

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tenure than after one year. Beyond 10 years of auditor tenure, the association between auditor tenure and misstatement duration is insignificant. In conclusion, the benefits of a fresh look exist only in the first 10 years of the auditor-client relationship.”

At several points in the paper, Singer and Zhang take note of the fact that the U.S. Public Company Accounting Oversight Board (PCAOB) issued a concept release in 2011 inviting comment on mandatory rotation of audit firms, an initiative that evoked an overwhelmingly negative response from the corporate world and even led to the passage by the House of Representatives of a bill prohibiting the board from requiring audit-firm rotation. Despite this strong opposition, the professors give credit to the PCAOB for its concern “that long auditor tenure may lead to impairment of auditor independence due to the development of a strong bond with the client over time.”

Further, they clearly believe their study, with its innovative research methodology, provides telling evidence in favor of renewed consideration of mandatory auditor rotations. “Overall,” they write, “these results support the PCAOB concern that a long auditor-client relationship may compromise audit quality.”

The study, entitled “Auditing Tenure and the Timeliness of Misstatement Discovery,” is in the March issue of *The Accounting Review*, published six times yearly by the **American Accounting Association**, a worldwide organization devoted to excellence in accounting education, research, and practice. Other journals published by the AAA and its specialty sections include *Auditing: A Journal of Practice and Theory*, *Accounting Horizons*, *Issues in Accounting Education*, *Behavioral Research in Accounting*, *Journal of Management Accounting Research*, *Journal of Information Systems*, *Journal of Financial Reporting*, *The Journal of the American Taxation Association*, and *Journal of Forensic Accounting Research*.

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