

# **AUDIT FIRM ROTATION AND AUDIT QUALITY: A LITERATURE REVIEW**

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## **Abstract**

The purpose of the paper is to create a bibliometric analysis of studies published in the Web of Science database on audit rotation (AR). In order to capture the effects of the EU audit reform on this topic, the period analysed has been divided in two intervals, 2007 – 2013 and 2014 – 2020. It has been determined that academic research on AR has increased significantly after the adoption of the EU reform. Improving audit quality is a common purpose of all parties in the corporate reporting ecosystem. However, there is no unanimously accepted opinion if the auditor rotation improves the audit quality or not.

## **Keywords**

Auditor rotation, audit quality, auditor independence, EU Directive

## **JEL Classification**

G01, M42, M48, H83

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## **Introduction**

Improving audit quality is a common purpose of all parties in the corporate reporting ecosystem. The audit scandals occurred at the beginning of 2000s (e.g., Enron, Arthur Andersen) followed by the financial crisis in 2008 have determined the authorities to ask itself whether external auditors are independent or not. Furthermore, the European audit oversight bodies started to look for different methods in order to increase investors' confidence and protect shareholders which, in the end, would lead to a higher financial stability. The independence of the auditor is essential to ensuring the quality of audit. This was one of the main goals of the International Federation of Accountants which have adopted in 2006 the rotation of audit partners after every 7 years, followed by the adoption of the European audit reform in 2014 which states the audit firms have to rotate after a period of 10 years.

### **1. Review of the scientific literature**

Audit quality has been scrutinised by the European Commission activities since its formation and has obtained substantial interest among auditors, audit committees and stakeholders in businesses around the world. The rotation of the audit firms began to be

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discussed more and more often as a measure to increase the audit independence and which will improve the audit quality. The auditor’s rotation is aimed at limiting the successive number of years in which the same auditor can provide the service of statutory financial audit of financial statements for a particular client. It is considered that if the auditor has been in place for a long time, the risk of over-familiarity and potential for conflicts of interests increases, which could have a negative impact on audit quality. Rotation may be mandatory or voluntary. As regards the mandatory rotation of the auditor, the main stated purpose of its introduction is to reduce the risk of non-compliant audits, to increase the independence of auditors and to achieve increased investor confidence in the audit opinion issued as well as in the financial statements (Barton, 2002).

In the last two decades, discussions on how audit quality can be improved have intensified among academic researchers as well as authorities. The results are diverse, basically they are divided into two categories.

The European Commission argues that „the audit quality tends to suffer the longer the relationship exists because the auditor becomes too cozy with the client and he can become complacent, and protects the audit income stream as a top priority” (Docket 037: Concept Release on Auditor Independence and Audit Firm Rotation, 2012)

The proponents of mandatory audit firm rotation support the European Commission decision and agree that the AR brings many advantages. First, „it establishes a limit on the continuous stream of audit fees. This will significantly free the auditor from pressure by clients to accept improper agreements. It would also have the benefit of a new and fresh evaluation of a client's internal controls and financial reporting. It would eliminate long-term cozy improper relationships between the auditor and its client. And it would eliminate further influences on the audit firm's decisions when many of the audit firm's partners, managers and staff have accepted positions with the client.” (Docket 037: Concept Release on Auditor Independence and Audit Firm Rotation, 2012)

However, there are voices against the mandatory audit firm rotation. Basically the critics use two arguments. The first one is about the lack of audit quality and knowledge of the client in the first years after the rotation (Cameran et al. 2015). And secondly, additional costs of changing auditors (Dumitrescu et al. 2021).

Based on the previous studies on audit rotation, it is clear that the rotation could bring either a positive or a negative impact on audit quality. The contradictory results of the previous studies could be caused by different reasons such as the proxies used for the measurement of audit quality or the research method used by academics.

**Table no 1. Brief of some studies on the auditor rotation’s effects on audit quality**

<b>Author</b>	<b>Proxy</b>	<b>Result</b>
Garcia-Blandon	Management estimates and	The main result of the study finds that audit mandates over 10 years do not have a lower audit

Author	Proxy	Result
et al (2020)	accounting restatements	quality than other audits. In fact, this study provides some evidence of a higher audit quality for these firms.
Cameran et al (2015)	Accounting conservatism and abnormal working capital accruals	The study reveals that the auditor becomes more conservative in the last years before the mandatory rotation.
Harber et al (2020)	Audit fees	It is established that considerable costs will be imposed on audit firms in the form of „start-up and transition costs“. Although the auditors will try to recover these costs with fee increases, this will probably not be allowed by the clients, which will lead to a tightening of the audit firm's profits. From the clients' perspective, the costs will be in the form of audit inefficiency that will translate into staff time and interruptions, caused by the fact that the incoming auditors are less familiar with the complexities of the business.
Rahmina et al (2014)	questionnaire	The results of this research show that, in general, the independence of the auditor, the audit mandate and the audit fee have a positive influence on the quality of the audit.
Bobbie et al (2011)	questionnaire	Results based on 212 responses suggest that loan officers do perceive an improvement in independence when the entity rotates their auditors.

Source: Own creation based on the data from Web of Science database

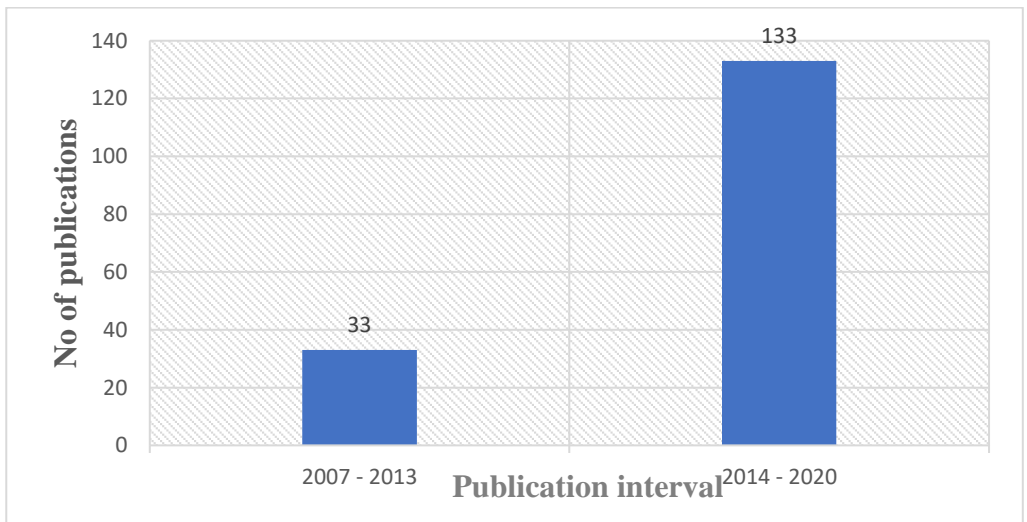
## 2. Research methodology

This research aims to investigate how much has been discussed about auditor rotation before and after the adoption of the European Union (EU) Audit Reform. The section provides details about the keywords occurrences and their strength divided between two equal intervals: 2007 – 2013 and 2014 – 2020. This study was conducted through a bibliometric analysis using VOS viewer in order to create a network map of co-occurring keywords sourced from the most important papers published in web of science collection.

Bibliometric is a new discipline which operates with statistical techniques in order to explore the scientific dissemination process by adapting to written documents (Antwi, 2021). The main objective of the bibliometric analysis is to obtain valuable information by collecting data on a certain topic from different databases in order to gain a better understanding of the importance of the topic.

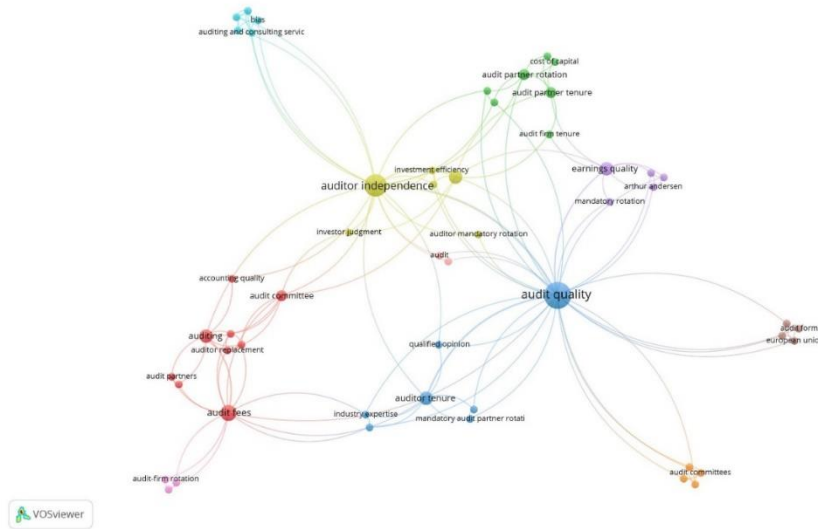
### 3. Results and discussion

Based on the Web of Science database, 166 articles have been selected for the literature review. These articles are related to different aspects of audit rotation. Results have revealed 33 papers about the auditor rotation which have been published in the first interval selected while the number of the papers increased up to 133 during the second interval. This can be explained through the impact of the major reform undertaken by the European Commission.



**Figure no 1: Publications related to the auditor rotation regulation**

Using the VOSviewer tool, it was created a keyword map illustrating the main areas of focus in terms of audit rotation (see Figure 2). The figure below illustrates the association between the aspects related to the auditor rotation during the period between 2007 – 2013. Based on the keyword map, the results suggest that audit rotation is analysed in conjunction with some core aspects (audit quality, auditor independence, audit fees etc).



**Figure no 2: Keyword mapping in the period 2007 - 2013**

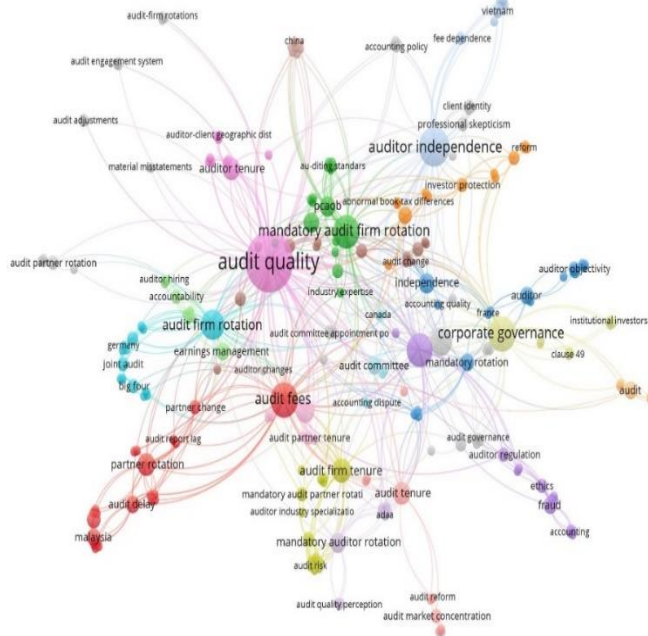
During the period 2007 – 2013 the first two keywords used by researchers in their papers regarding the auditor rotation were “audit quality” and “auditor independence”. It can be observed that audit committee and audit partner tenure are in the top 10 most linked words with the auditor rotation. It argues the importance of the audit committee in assuring the audit quality as well as the fact that before 2014 EU countries applied the audit partner rotation.

**Table no 2. 10 Keywords used in the period between 2007 - 2013**

Keywords	Occurrences	Total link strength
audit quality	11	37
auditor independence	8	26
audit fees	4	15
Auditing	3	10
auditor rotation	3	10
auditor tenure	3	10
earnings quality	3	9
audit committee	2	7
audit partner tenure	2	6

Source: Own creation based on the data from VOSviewer

The figure below illustrates the association between the aspects related to the auditor rotation during the period 2014 – 2020. The mapping has expanded significantly but the interesting thing which can be noticed is that both the keywords occurrence and total link strength have increased.



**Figure no 3: Keyword mapping in the period 2014 – 2020**

During the period 2014 – 2020 the first two keywords used by researchers in their papers regarding the auditor rotation remained “audit quality” and “audit independence”. However, it can be observed that the number of the studies conducted for this topic has increased and they are much more linked to the audit quality and auditor independence.

Another interesting thing is that it can be observed that the Directive 56/2014 changed the course of the discussions from voluntary auditor rotation to the mandatory auditor rotation. If before 2014 the syntagma “audit partner tenure” was analyzed, after the adoption of the new EU audit reform “mandatory audit firm rotation”, “audit firm rotation” and “firm tenure” became the new hot keywords searched about the auditor rotation.

**Table no 3. 10 Keywords used in the period between 2014 - 2020**

Keywords	Occurrences	Total link strength
audit quality	36	145
auditor independence	15	59
corporate governance	12	49
mandatory audit firm rotation	11	49
audit fees	12	46
auditor rotation	11	44
audit firm rotation	9	40
auditing	8	29
discretionary accruals	6	29
audit firm tenure	6	28

*Source:* Own creation based on the data from VOSviewer

### Conclusions

The new rule of the mandatory auditor rotation has become a hot topic among auditors as well as academics since everyone is wondering how mandatory audit firm rotation will affect audit quality and if it corresponds with its intentions.

This study analysed 166 studies published between 2007 – 2020 in the Web of Science database on audit rotation (AR). The number of studies increased after the adoption of the EU audit reform which states that the public interest entities must apply a rotation policy in the next years.

As can be seen, auditor rotation continues to be an attractive topic in the scientific arena. The results of the paper have illustrated the orientation of the studies performed in the last decades. The findings in this study may be of interest to board of directors and audit committees in establishing policies regarding rotating the audit firm. The conclusions reflect the increasing trend in the AR field and provide a better understanding to anyone interested on this topic. Moreover, the study contributes to presenting a general framework due to the increasing numbers of new articles.

The results of this study are limited to the syntagma “auditor rotation”. Thus, the findings may not be propagated to other keywords groups. Furthermore, the sample selection was

restricted to a part of the papers published in web of science collection. Future research could expand the search database. Other scenarios involving various aspects regarding the auditor rotation could also be explored, as well as the extension of the interval.

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