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Research report

## Can clients of economically dependent auditors benefit from voluntary audit firm rotation? An experiment with lenders

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## ABSTRACT

This study utilizes a nationwide random selection of 111 lenders in a  $2 \times 2$  between-subjects experiment to determine whether the level of an auditor's economic dependence on a client and type of auditor rotation affect lenders' independence and reliability perceptions and decisions to lend money to a potential borrower. Previous literature shows that financial statement users use client importance as a measure of audit quality when revenue streams are not equal across clients. This can negatively affect perceptions of independence and financial statement reliability. As United States regulators look for ways to improve audit quality under the current partner rotation mandate, this study explores whether an audited entity that voluntarily adopts a policy of firm rotation can mitigate the negative effects of the auditor's dependence on the client. Findings suggest that lenders view clients of economically dependent auditors (CEDA) as less independent from its auditor and perceive its financials as less reliable than clients without a dependent auditor (non-CEDA). Lenders are less likely to grant a loan to CEDA. However, under firm rotation, there is not only an increase in lenders' perceptions of reliability of CEDA financials, but also no difference in perceptions of reliability of CEDA and non-CEDA financials.

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## 1. Introduction

Bank loans are the primary source of external loans for corporations, and lenders make loan decisions based on an information framework consisting of financial and non-financial information. When deciding to extend a loan, lenders' knowledge that the loan requester is economically important to its auditor may become relevant information for this framework. Lenders may perceive that the requester is not independent of its auditor, which may negatively impact financial statement reliability perceptions and may lead the lender to deny the loan request. In addition, it is common for local offices of even large audit firms to take on economically important clients, possibly leading the audit firm to depend on continuous receipt of fees from that client. This may negatively affect perceptions of audit quality (Barlett, 1993; Beattie, Brandt, & Fearnley, 1999; DeAngelo, 1981; Firth, 1980; Gul, 1991; Lowe & Pany, 1995; Pany & Reckers, 1980; Teoh & Lim, 1996; Wallman, 1996). Clients of economically dependent auditors (CEDA) that are seeking loans may benefit from implementing procedures to improve lenders' independence perceptions.

This research explores the effects of client importance on lenders' perceptions of independence, financial statement reliability, and decisions to grant a loan. In addition, this research

suggests a voluntary audit firm rotation policy for CEDA as a method of mitigating possible negative effects of its auditor's economic dependence, thereby closely replicating and extending the works of Schneider (2010) and (2011) and Daniels and Booker (2011).

## 2. Background, literature review, and hypotheses

## 2.1. The economic theory of auditor independence and economic dependence

According to the economic theory of auditor independence, an auditor may have incentives to compromise its independence for a client that represents a high proportion of quasi-rents (the percentage of the total revenue stream attributable to one client, the basis for CEDA in this study), or a continuous revenue stream (DeAngelo, 1981; Reynolds & Francis, 2001). Past PCAOB Chairman James Doty expressed concern about a seemingly inherent desire of an auditor to maintain a client and the struggles that desire may present over time (Doty, 2012). Stakeholders, who usually use auditor size to represent a measure of audit quality, use client importance as an alternative measure of audit quality when revenue streams are not identical across clients (DeAngelo, 1981). When this occurs, perceptions of CEDA financial statement reliability may suffer amid doubt that its auditor can withstand client

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management pressure during an auditor/client conflict (Gul, 1991; Mautz & Sharaf, 1961). This phenomenon occurs at the decision-making local office level of a firm, which is responsible for contracting with clients, administering audits, and issuing audit reports (Wallman, 1996).

Some studies find no effect of client importance on auditor independence, audit quality, or reporting, which supports the notion of reputation protection (Chung & Kallapur, 2003; Craswell, Stokes, & Laughton, 2002; Gaver & Paterson, 2007; Hunt & Lulseged, 2007; Kerler & Brandon, 2010; Li, 2010; Pany & Reckers, 1980; Reynolds & Francis, 2001; Schneider, 2010). However, others indicate that local office-level auditors who are economically dependent on their clients are subject to greater management influence than those who are not dependent, and may even report more favorably on their local clients' financials (Ahmed, Duellman, & Abdel-Meguid, 2006; Bartlett, 1993; Beattie et al., 1999; Brandon & Mueller, 2006; Chan, Lin, & Mo, 2006; Chi, Douthett, & Lisic, 2012; Firth, 1980; Gul, 1991; Hoitash, Markelevich, & Barragato, 2007; Khurana & Raman, 2006; Lowe & Pany, 1995; Teoh & Lim, 1996). Using investors, Schneider (2011) finds that knowledge of an auditor's revenue dependence on a client negatively affects investment decisions. This study presents the following hypotheses based on the economic theory of auditor independence:

H1a: Lenders perceive the auditor of CEDA to be less independent than a non-CEDA auditor.

H1b: Lenders perceive the financial statements of CEDA to be less reliable than those of a client with a non-CEDA auditor.

H1c: Lenders are less likely to approve the loan request of CEDA than that of a client with a non-CEDA auditor.

## 2.2. Rotation and economic dependence interaction

In the U.S., audit partner rotation after the completion of every fifth year is the primary means for auditors to maintain independence (U.S. House of Representatives 2002, also known as Sarbanes Oxley, Section 203). Even so, SOX 2002 also urged examination of firm rotation as a means of increasing independence. PCAOB Concept Release 2011–2006 cites continuing audit failures despite the partner rotation mandate (PCAOB 2011).<sup>1</sup> Though the causes of audit failure are complex, the Concept Release asserts that firm rotation alleviates at least one component of audit failure, which is lack of independence stemming from long auditor tenure.

Some experimental studies find that firm rotation leads to better perceptions of independence, audit quality, reliability, ability to withstand management conflict with the auditor, and even lower audit firm liability (Arel, Brody, & Pany, 2006; Bowlin, Hobson, & Piercey, 2015; Daniels & Booker, 2011; Dopuch, King, & Schwartz, 2001; Gates, Lowe, & Reckers, 2007; Jennings, Pany, & Reckers, 2006; Wang & Tuttle, 2009). Daniels and Booker (2011), which the current study extends by adding a client importance measure, find that bank loan officers perceive an audit firm that rotates as more independent than a firm that does not rotate. Finally, Kaplan and Mauldin (2008) find no significant difference in the amount of an overstatement believed to be recorded by the client or perceived auditor independence under firm rotation and partner rotation conditions. Whereas Kaplan and Mauldin (2008) use student participants, the current study utilizes lenders, who may have differing perceptions about independence and reliability and may make different decisions than users with little experience. This study posits that firm rotation also produces the best perceptions

of CEDAs' auditor independence and financial statement reliability, and it presents the following hypotheses:

H2a: Firm rotation improves perceptions of independence of CEDA audit firms.

H2b: Firm rotation improves perceptions of CEDA financial statement reliability.

H2c: Lenders are more likely to grant a loan to CEDA under firm rotation than partner rotation.

## 3. Research design

### 3.1. Participants

The sample comprises 1200 commercial lenders in the U.S., randomly selected from the Hugo Dunhill Company database of 12,000 loan officers.<sup>2</sup> Lenders are randomly assigned to one of four treatments. Responses, excluding those who failed the manipulation check, total 111 for a response rate of 9.47%. Respondents have an average of 24.10 years of experience granting loans, 28.77 years of banking experience, and devote 63.27% of their job to loans. Approximately 90% of respondents work at banks with assets less than \$10 billion, with the biggest concentration (51.4%) of respondents working at banks with assets of more the \$100 million but less than one billion dollars, indicating that most respondents have experience handling the assets of small- to medium-sized banks.<sup>3</sup> Over 87% (87.3%) of lenders are the President, Vice President, or CEO of the bank, and 96.4% of respondents have a bachelor's degree or higher.

### 3.2. Task and dependent variables

Loan officers receive the case reading, which closely mimics Schneider and Church (2008). Dolphin's audited financials for the year ended June 30, 2012 are also presented. Dolphin Book Sellers wishes to obtain a \$5,000,000 loan from a bank. The case presents, along with other background information, Dolphin's rotation policy (partner or firm) and the level of its auditor's economic dependence (2% or 60%, CEDA, of audit revenues received from all clients). Subjects are given five questions about the case and told to assume that there are no loan size or fund availability restrictions. Lenders sealed their completed questions in an envelope and proceeded to the manipulation check and demographics, which were also sealed and returned to the author. The five questions measure the dependent variables of lenders' perceptions of independence, perceptions of financial statement reliability (for both unintentional and intentional mistakes and omissions), and loan decision (approve/reject and probability of extending the loan).

## 4. Results and implications

According to Table 1, there is a statistically significant difference between perceptions of independence (H1a) for subjects

<sup>2</sup> The university's Institutional Review Board approved the use of human participants in this study.

<sup>3</sup> A previous commenter mentioned the possibility of lenders expressing a difference in perceptions according to the size of the institution for which they worked. After running an ANOVA or Chi-Square for sensitivity, the author finds no significant differences in the lenders' responses to the five experimental questions based on four bank asset size groups (Independence:  $p=.192$ , Reliability Unintentional:  $p=.419$ , Reliability Intentional:  $p=.316$ , Approve:  $p=.060$ , Probability:  $p=.114$ ). Also, there are no significant differences according to level of education (Independence:  $p=.319$ , Reliability Unintentional:  $p=.330$ , Reliability Intentional:  $p=.349$ , Approve:  $p=.687$ , Probability:  $p=.315$ ) or position within the bank ((Independence:  $p=.463$ , Reliability Unintentional:  $p=.121$ , Reliability Intentional:  $p=.423$ , Approve:  $p=.463$ , Probability:  $p=.185$ ) (untabulated).

<sup>1</sup> Audit failure occurs when auditors do not approach the audit with required independence, objectivity, and/or professional skepticism, and the opinion given on the financial statements cannot be supported.

**Table 1**  
Descriptive statistics and two-way ANOVA for independence<sup>a</sup>.

Panel A: Cell means and (standard deviations)			
	60%	2%	Total
Partner	6.481 (2.1550) n = 27	8.240 (1.7388) n = 25	7.327 (2.1395) n = 52
Firm	7.074 (2.2690) n = 27	8.844 (1.1390) n = 32	8.034 (1.9473) n = 59
Total	6.778 (2.2120) n = 54	8.579 (1.4510) n = 57	7.703 (2.0609) n = 111

  

Panel B: Statistical analysis					
Source	Hypothesis	df	Mean squares	F-value	p-value
Rotation		1	9.849	2.868	0.047
Economic Dependence	H1a	1	85.658	24.949	0.000
Rotation*econ. Dependence	H2a	1	0.001	0.000	0.494

<sup>a</sup> The dependent variable in all panels is the response on an 11-point scale (0 = not independent at all; 10 = completely independent) to the following question: "How independent do you believe Woods & Lee, CPAs are in their role as external auditors of Dolphin's financial statements?"

**Table 2**  
Descriptive statistics and two-way ANOVA for reliability (intentional)<sup>a</sup>.

Panel A: Cell means and (standard deviations) <sup>b</sup>			
	60%	2%	Total
Partner	6.846 (2.0917) n = 26	8.520 (1.5033) n = 25	7.667 (1.9967) n = 51
Firm	7.852 (2.1250) n = 27	8.344 (2.0574) n = 32	8.119 (2.0851) n = 59
Total	7.358 (2.1492) n = 53	8.421 (1.8220) n = 57	7.909 (2.0478) n = 110 <sup>b</sup>

  

Panel B: Statistical analysis					
Source	Hypothesis	df	Mean squares	F-value	p-value
Rotation		1	4.688	1.205	0.138
Economic dependence	H1b	1	31.962	8.218	0.003
Rotation*econ. dependence	H2b	1	9.520	2.448	0.061

\* Represents the interaction of the rotation variable (partner or firm) with the economic dependence variable (2% or 60%).

<sup>a</sup> The dependent variable in all panels is the response on an 11-point scale (0 = not confident at all; 10 = completely confident) to the following question: "How confident are you that the audited financial statements are free from intentional misstatements or omissions?"

<sup>b</sup> One respondent did not answer this question.

receiving the CEDA and the non-CEDA condition ( $df = 1$ ,  $F = 24.949$ ,  $p = 0.000$ ). Respondents receiving the non-CEDA condition rate perceptions of auditor independence at a mean of 8.579, while respondents receiving the CEDA rate perceptions of auditor independence at a mean of 6.778. Partial eta squared determines that these results are practically significant, and economic dependence explains 18.9% (untabulated) of the variance in perceptions of independence. Findings support H1a and imply that lenders perceive the auditor of CEDA as less independent than the non-CEDA auditor. H2a is not supported and firm rotation does not make a difference in lenders' independence perceptions of CEDA ( $df = 1$ ,  $F = 0.000$ ,  $p = 0.494$ ).

This study divides reliability perceptions into unintentional and intentional (Table 2) misstatements or omissions. Lenders view the financial statements of CEDA as less reliable (prone to more unintentional misstatements and omissions), at a mean of 7.037, than the financial statements of the client of the non-CEDA auditor, at a mean of 7.614. The difference between these two means produces a marginally significant result ( $df = 1$ ,  $F = 2.327$ ,

$p = 0.065$ , untabulated). Table 2 indicates that lenders view the financial statements of CEDA as less reliable (prone to more intentional misstatements and omissions) than the financial statements of the client of the non-CEDA auditor ( $df = 1$ ,  $F = 8.218$ ,  $p = 0.003$ ). Means are 7.358 and 8.421, respectively. Results for intentional mistakes and omissions support H1b, and the partial eta squared indicates that 7.2% of the variance in reliability intentional is explained by client importance, indicating practical significance as well.

There is a marginally significant interaction effect for reliability (intentional). According to main effect results in Table 2, overall, lenders perceive financial statements of CEDA to be less reliable than those of non-CEDA. However, according to Table 2, this result does not hold for subjects receiving the firm rotation condition ( $df = 1$ ,  $F = 2.448$ ,  $p = 0.061$ ). Under firm rotation, lenders show an increase in confidence that the financials of CEDA are free from intentional misstatements and omissions, from a mean of 6.846 under partner rotation to 7.852 under firm rotation. Also, under firm rotation, lenders view no signifi-

**Table 3**  
Descriptive statistics and logistic regression for loan decision—recommendation<sup>a</sup>.

Panel A: Percentage of participants per condition that approved <sup>b</sup>					
		60%	2%		Total
Partner		40.9	78.3		60.0
Firm		50.0	64.5		58.2
Total		45.7	70.4		

  

Panel B: Statistical analysis					
Source	Hypothesis	Estimate	Standard error	Chi Square	p-value
Rotation		−0.368	0.596	0.381	0.269
Economic dependence	H1c	−1.649	0.666	6.127	0.007
Rotation* econ. dependence	H2c	1.051	0.867	1.470	0.113

\* Represents the interaction of the rotation variable (partner or firm) with the economic dependence variable (2% or 60%).

<sup>a</sup> The dependent variable in all panels is the response approve or reject to the following question: “What recommendation would you make on the loan application?”

<sup>b</sup> Eleven respondents did not answer this question. Percentages are based on 100 responses.

cant difference in the reliability of the financial statements of the CEDA and the client of the non-CEDA auditor (means of 7.852 and 8.344, respectively). Though the interaction effect is not statistically strong, findings support H2b concerning intentional mistakes and omissions. No such significant interaction effect exists for unintentional mistakes and omissions ( $df = 1$ ,  $F = 0.053$ ,  $p = 0.410$ , untabulated). Because intentional mistakes and omissions may carry a heavier weight than those that are unintentional and may indicate fraud, collusion, or other illegal activities, CEDA may wish to consider firm rotation to close the gap in perceived reliability with their non-CEDA counterparts.

According to Table 3, a significantly lower percentage of lenders approve the loan for CEDA (45.7%) as compared to non-CEDA (70.4%, Chi Square = 6.127,  $p = 0.007$ ). The probability of that lenders will grant the loan is marginally significant ( $df = 1$ ,  $F = 2.085$ ,  $p = 0.076$ , untabulated). The results for loan approval (the dichotomous decision) support H1c and demonstrate that CEDA are at a disadvantage when it comes to getting a loan from a financial institution. The percentage of lenders approving the loan for CEDA under firm rotation (50%) is higher than the approval percentage under partner rotation (40.9%). While these percentages are consistent with the notion that firm rotation heightens CEDA chances of securing a loan, the interaction effect for approval percentages is not significant (Chi Square = 1.470,  $p = 0.113$ ), nor is the interaction effect for probability of loan approval significant ( $F = 0.594$ ,  $p = 0.222$ , untabulated). Therefore, H2c is not supported.

## 5. Summary, limitations, and future research

This research suggests that CEDA suffer from negative perceptions of independence of its auditor, financial statement reliability, and are at a disadvantage for securing debt funding when compared to their non-CEDA counterparts. It extends the client importance literature by suggesting that voluntary audit firm rotation helps to even the playing field for CEDA and non-CEDA concerning lenders' perceptions of reliability. Under a voluntary firm rotation policy, lenders' perceptions of CEDA financial statement reliability improve, and there is no longer a significant difference in reliability perceptions of CEDA as compared to non-CEDA. Though this did not translate to an approved loan for CEDA in this study, CEDA proactive strategy of voluntary firm rotation may be the key to favorable capital decisions by other investors or lenders, under different conditions.

Extant research often views the journey from independence to reliability to a financial decision as a direct path (Orren, 1997). This research fails to find an interaction effect for independence,

yet lenders perceive improved CEDA financial statement reliability under firm rotation. This suggests that lenders may always perceive CEDA as too important with a looming ability to influence the auditor, but lenders will not think that CEDA exercised that ability only if CEDA are proactive and implement a firm rotation policy. Future research should also explore the path of independence to reliability to a financial decision. Future research should also include more informative measures such as financials for several years and should attempt to gather data from lenders at larger banks. Due to random nationwide sample selection, this study can only be generalized to lenders at small- to medium-sized banks who have the task of approving or rejecting a loan of \$5,000,000.

Large companies may be an important source of revenue for a local audit office, and this study implies that they should consider voluntary audit firm rotation if they want lenders to perceive their financials to be equally reliable as their non-CEDA counterparts. Despite auditing quality issues that affect reliability, U.S. regulators continue to pass standards to improve audit quality through other means, such as transparency and the auditor's report. However, the European Union has implemented mandatory firm rotation after every tenth audit year to improve audit quality in June 2016. Even so, Casterella and Johnston (2013) suggest that future research should differentiate between the implications of mandatory and voluntary firm rotation. This study's results imply that voluntary firm rotation assists in mitigating negative effects for a subset of companies who identify as important to their auditor. Regulators should consider requiring rotation for this subset of public companies, and allow a firm tenure time beyond 5 years to satisfy continuity issues expressed by opponents of firm rotation while satisfying reliability perception issues that may manifest in the decision frameworks of those providing capital to CEDA.

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