

The Propensity for Mandatory Audit Rotation and Its Impact on Earnings Management: An Evidence from the United Kingdom

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Abstract: In the recent years, the frequent occurrences of massive accounting scandals related to earnings management have provoked alarm in the financial market about the accuracy of financial reporting statements as well as the credibility of external auditors. Therefore, Mandatory Audit Rotation (MAR) rules have been enacted in many countries in order to tackle these enormous accounting frauds. In the United Kingdom (UK), since the MAR rule introduced in 2012, there have not any researchers investigating the effectiveness of this rule. Hence, this study is undertaken to examine the effectiveness and the necessity of the latest MAR rule in the UK by testing the influence of audit rotation activities and audit tenure on earnings management of companies in the FTSE 350 Index. Practical implications of this study not only prove that FTSE 350 companies should be required to shorten their audit tenure by rotating their audit engagement more often in order to decline the degree of earnings management, but they also strengthen support for the essentiality of MAR legislations in the UK when showing that longer audit tenure actually leads to more earnings management of FTSE 350 companies.

Keywords: Mandatory Audit Rotation (MAR), external auditors credibility, earnings management

Introduction

The credibility of financial statements and the efficiency of audit functions have been blooming concerning problems in the worldwide financial market since the beginning of the 21st century after a large number of accounting scandals occurred throughout the world. In response to this burning issue, many countries (e.g., the United States of America (U.S.) in 2002; the United Kingdom (UK) in 2012; the European Union (EU) in 2014) have enacted audit rotation rules in order to shorten the audit tenure and to enhance auditor independence. Since then, the

effectiveness of audit rotation has been the subjects of many academic researchers; however, the final agreements have not been reached yet.

In the UK, all companies listed in the FTSE 350 Index have been required to tender their audit engagement every ten years since 2012 (The UK Corporate Governance Code 2012). Although there were several researchers investigating the influence of audit rotation on earnings management in the UK financial market in the past, there has been little empirical study about its actual impact after the introduction of the new mandatory audit rotation rule in 2012. Thus, it is required to explore the capability and the essentiality of this new rule in addressing earnings management issues in the UK.

The intended sample used in this study to test the research' hypotheses consists of all companies listed in the FTSE 350 Index in the UK. The investigated period of time is a ten-year period between 2006 and 2015. Following previous research by Matsumoto (2002); Davis et al., (2009), this study uses discretionary accruals as a proxy to estimate the degree of earnings management. Additionally, the number of auditors employed by each firm in the FTSE 350 Index in the period between 2006 and 2015 represents audit rotation activities in this research, whilst audit tenure is defined as the length of a firm-auditor engagement.

The results acquired from this research suggest two main points. As can be implied from the first result, the increasing number of auditors engaged by each firm in ten years contributes to the decline in the degree of earnings management. Thus, this result has affirmed the effectiveness of MAR on lowering earnings management in the UK. In terms of the second result, longer tenure is found to result in more earnings management strategies. Hence, the second result from this study has emphasized the fundamental need of MAR enactment in the UK, which can definitely help to shorten the harmful long audit tenure. In general, it may be evident that both main results show support for the success of MAR in confronting earnings management issue and the essentiality of MAR legislation in the UK.

The remaining parts of this study are organized as follows. Firstly, the research demonstrates theoretical information about earnings management and presents the review of prior related research, which then paves the way for the development of two hypotheses on the effect of audit rotation activities and audit tenure on earnings management. The following part illustrates the research method and the formation of two regression models. Finally, the research draws conclusions and makes several suggestions for future research.

1 Literature review

1.1 Earnings Management

Earnings management is the situation in an organization when managers manipulate financial reports legally or illegally to demonstrate an untrue picture of the firm's financial conditions with the hope of meeting earnings expectations.

The main motivation of earnings management roots from the significant influence of earnings on the decision of investors and stockholders, since investors usually consider earnings as an indicator for a firm's financial health and its future prospects. In reality, the strong reaction of the stock market or investors and bondholders to firms' earnings announcements under specific conditions has been suggested in academic research carried out by Bailey, Karolyi and Salva (2006). In addition, managers, especially those with high equity incentives, are so sensitive to future stock price performance that they tend to manipulate their earnings in order to satisfy analysts' expectations (Cheng and Warfield, 2005). All in all, it is the influence of earnings reports on investor behaviour that incentivize managers to choose their earnings-optimizing financial reporting strategies (Abarbanell and Lehavy, 2003; Goel and Thakor, 2003).

1.2 Audit rotation

1.2.1 Overview of mandatory audit rotation rules

To deal with severe accounting frauds, in the early 21st century, the Sarbanes-Oxley Act (SOX) requiring five-year audit partner rotation was enacted in July 2002 by The U.S. Congress. After that, the requirement for five-year mandatory audit partner rotation for listed audits was also introduced in 2004 by the Auditing Practices Board under the authorization of the Financial Reporting Council in the UK, targeting at improving financial reporting reliability and the independence of auditors. Then, in 2012, the Financial Reporting Council in the UK enacted a rule in the UK Corporate Governance Code which requires FTSE 350 companies to tender their audit every ten years. A similar legislation was also introduced in the EU for all EU public interest entities in June 2014.

1.2.2 Mandatory audit rotation activities

For those supporting MAR, they believe that audit rotation could bring 'a fresh look' (The Conference Board, 2003, p.39) to corporate's finance, and the work of an auditor could improve due to the peer pressure from his or her successor auditors. This perspective is strongly supported by Lu and Sivaramakrishnan

(2009), who state that MAR exerts a statistically positive impact on higher audit quality in the first years of an audit engagement by virtue of the ambition to provide more effective auditing methods of newly appointed external auditors. Furthermore, not only the first years but also the last years of an audit-client relationship can experience dramatic improvements in audit quality. According to Lennox et al. (2014), the peer review between predecessor and successor auditors paves the way for the higher detection of financial reporting frauds, which can result in the significant audit adjustment in last years of an audit term. On the other hand, a number of researchers demonstrate that low audit quality is likely to take place in the first several years of an auditing term due to the unfamiliarity of new auditors with their clients (e.g., Carcello and Nagy, 2004; Litt et al., 2014). Due to the unsolved conflicts and little research regarding the impact of MAR on earnings management or financial reporting enhancement in the UK since the new MAR regulation was adopted in 2012, one out of two main objectives of this study is to determine whether this MAR rule actually can make a great contribution to lessening earnings management of FTSE 350 companies. Based on the belief of MAR legislators and supporters, the first hypothesis is built as the following:

Hypothesis 1: More audit rotation activities have a statistically positive effect on lessening the degree of earnings management.

1.2.3 Audit tenure

One of the main purpose of the MAR is to shorten the audit tenure, which is believed to be the main cause of the decreasing in the auditors' independence. Hence, many researchers investigate in the relationship between audit tenure and audit credibility in order to test the effectiveness of the MAR rule.

To support for the idea of shortening the audit tenure, Lennox et al. (2014) proves that a strong mutual bond between auditors and firms in a long auditor-client relationship, which leads to poor audit quality and low independence, could be hampered thanks to MAR. Furthermore, several researchers have discovered that long tenure actually loosens auditors' independence, which then directly does harm to audit quality (e.g., Dopuch et al., 2001). As a result, the elimination of auditor independence and accounting frauds due to long auditor-client relationship may be considered as the most principal intention of MAR enactments. On the contrary, in the research of Myers et al. (2003), there is a decline in the discretionary accruals used in conjunction with long audit tenure, implying that a long auditing relationship could help to reinforce financial reporting quality. Explaining their result, Myers et al. (2003) emphasizes that long-term auditors would pay more attention to their clients' income-increasing and income-decreasing accruals, which could then prevent any earnings frauds. To summarize, the relationship between audit tenure and earnings management detection is still the contentious topic among academic researchers, and it needs to be determined in further research. In this study, the second hypothesis will evaluate the necessity for MAR enactment in the UK by

testing whether longer audit tenure can truly do harm to financial reporting credibility in the UK financial market. Consistent with the reason for MAR enactment, the second hypothesis of this research is given as follows:

Hypothesis 2: Longer audit tenure has a statistically positive influence on the increase in the degree of earnings management.

2 Methodology

2.1 Data

The sample firms used to answer the two research questions are all UK firms listed in FTSE 350 Index. The FTSE 350 companies are selected because the FTSE 350 Index consists of 350 largest UK companies listed in the London Stock Exchange, and FTSE 350 companies have been required by the Financial Reporting Council in the UK Corporate Governance Code to rotate their audit appointment every ten years since 2012. However, this study focuses on only 327 companies listed in FTSE 350 Index instead of 350 companies, since there are 23 companies containing either many missing data or no auditors' information.

All the data used in this research are secondary data. While auditors' information was obtained from the BVD database and annual financial reports of each firm in ten years, financial data for each company from 2006 to 2015 were acquired from the Datastream database.

Yearly historical financial data of FTSE 350 companies are scrutinized for the period between 2006 and 2015, because this period experienced a variety of significant occurrences in the worldwide financial market. the ten-year audit tendering rule for FTSE 350 companies in 2012.

2.2 Multivariate regression models

There are two multivariate regression models built to test two hypotheses of this research. Regression models adopted in this research were developed by Dechow et al. (1995) from the Jones Model (1991). This study uses Eviews for the statistical and econometrics analysis. The method adopted to estimate two regression models mentioned above will be Ordinary Least Square (OLS) method.

The first target of this study is to examine the effectiveness of MAR rule in the UK by exploring whether the audit rotation activities can make a contribution to preventing earnings management strategies. Therefore, the hypothesis is given below:

Hypothesis 1: More audit rotation activities have a statistically positive effect on lessening the degree of earnings management.

The first multivariate regression model to test Hypothesis 1 is estimated as the following:

$$\begin{aligned} LDA_{i,t} = & \beta_0 + \beta_1 NUMBER_OF_AUDITORS \\ & + \beta_2 CHANGE_ONCE \\ & + \beta_3 CHANGE_MORE_THAN_ONCE + \beta_4 BIG4 \\ & + \beta_5 SIZE_{(CONTROL)} + \beta_6 AGE_{i,t (CONTROL)} \\ & + \beta_7 ROA_{i,t (CONTROL)} \\ & + \beta_8 MARKET_TO_BOOK_{i,t (CONTROL)} \\ & + \beta_9 LEVERAGE_{i,t (CONTROL)} \\ & + \beta_{10} CASHFLOW_{i,t (CONTROL)} \\ & + \varepsilon_{i,t} \end{aligned}$$

On the other hand, the second goal of this study is to test the necessity of MAR enactment. As mentioned in the Literature Review chapter, accounting frauds are thought to have their roots from long audit tenure MAR legislators and supporters; thus, it is necessary to enact MAR rules. Therefore, the essentiality of MAR enactment in the UK will be reaffirmed if longer audit tenure is proved to result in more earnings management if FTSE 350 companies. Based on this belief, the second hypothesis of this study is given below:

Hypothesis 2: Longer audit tenure has a statistically positive influence on the increase in the degree of earnings management.

In order to test Hypothesis 2, the multivariate regression model is built as the following:

$$\begin{aligned} LDA_{i,t} = & \beta_0 + \beta_1 TENURE + \beta_2 SHORT + \beta_3 LONG + \beta_4 BIG4 \\ & + \beta_5 SIZE_{(CONTROL)} + \beta_6 AGE_{i,t (CONTROL)} + \beta_7 ROA_{i,t (CONTROL)} \\ & + \beta_8 MARKET_TO_BOOK_{i,t (CONTROL)} + \beta_9 LEVERAGE_{i,t (CONTROL)} \\ & + \beta_{10} CASHFLOW_{i,t (CONTROL)} \\ & + \varepsilon_{i,t} \end{aligned}$$

3 Findings and conclusion

This analysis is built with the main intention to explore the effectiveness and the necessity of MAR enactment in the UK. This study is designed in the context of over three years after the MAR enacted in the UK, so that it can help to satisfy the urgent need for research about MAR and provide the latest evidence from the UK financial market to this academic field. There are two questions designed in this research. The first question aims to test the capability of MAR in the UK by examining whether more audit rotation activities, which are presented by the number of auditors employed by FTSE 350 companies from 2006 to 2015, can contribute to lowering the degree of earnings management. The second one tries to

confirm the necessity of MAR enactment by scrutinizing whether longer audit tenure actually results in the rising level of earnings management.

Consistent with the research's first hypothesis, the corresponding regression model reveals an evident fact that the increasing number of auditors engaged in ten years paves the way for the lower discretionary accruals. As this result demonstrates the fact that audit rotation activities indeed contribute to lessening the degree of earnings management of FTSE 350 companies, it has provided support for the effectiveness of MAR in the UK. In terms of the second research question, the result from the corresponding regression model has stated that the longer the audit tenure, the more earnings management reported from FTSE 350 companies. Hence, this result helps to reaffirm the fact that MAR is truly needed to be enacted in the UK to eliminate the root of earnings management of FTSE 350 companies – long audit tenure.

Further research can be conducted with the purpose of recommending either the number of times that each company should switch its auditor within a specific period of time, or the best appropriate audit tenure of each auditor-client relationship to achieve the ultimate objectives of MAR. Furthermore, investigating how auditor switches occurring within or outside Big Four affects the capability of MAR will be another helpful addition to this research area.

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