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INCREASED AUDITOR INDEPENDENCE BY EXTERNAL ROTATION AND SEPARATING AUDIT AND NON AUDIT DUTIES? - A NOTE ON THE EUROPEAN AUDIT REGULATION

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Abstract

The European audit reform contains the implementation of an external mandatory auditor rotation (audit firm rotation) and a separation of audit and non audit duties to increase auditor independence. The central question is, whether these regulation measures are connected with an increased accounting and audit quality. First, this article presents an agency theoretical foundation of auditor independence. Then, a state of the art analysis of empirical research illustrates these ambivalent results, so that the economic need for the audit market regulation in Europe is controversial.

Key Words: Low Balling, Audit Quality, Empirical Audit Research, Auditor Independence, Rota-Tion, Audit Market Concentration, Consulting, Audit Fees, Principal Agent Theory, Expectation Gap

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Introduction

The professional standards of accountants and auditors in Europe were modernized in April 2014 (European Parliament, 2014). The current audit market regulation is a reaction to the capital markets' reduced reliance in the decision usefulness of financial accounting and auditing after the financial crisis. The European standard setter tries to increase audit quality by reducing the expectation gap, increasing auditor independence and preventing further audit market concentration. Based on actual autonomy (auditor independence in fact) as well as on autonomy perceived as such by the capital markets (auditor independence in appearance), the European regulation contain several measures to strengthen auditor independence.

A mandatory external rotation as well as a separation of audit and non-audit services represent the major contents that should strengthen the auditor independence. Yet, the European standard setter did not stipulate explicitly the prohibition of services with regard to the compatibility of audit and non-audit services on the lines of the US Sarbanes Oxley Act and the EC recommendation (EC, 2002). In fact a principle-based approach has been applied. Up to now, legal and tax consultancy services are allowed parallel to audit while the self-review prohibition is guaranteed. According to the current regulation, all expert services which are cited in the “black list”, are prohibited in general, provided that the audit is carried out at the client at the same time. Tax consulting and estimation duties could be conducted if the link to the financial statement is not material, the auditor explains the consequences for the financial statement in the audit report and the audit committee gives an approval.

In combination with the separation of audit and non-audit duties, the European audit reform contains the implementation of an external rotation of the audit firm. Based on the current 8th EC directive, all responsible partners of auditing companies have been obligated to an internal rotation every seven years. After a cooling off period of two years, the auditor in charge may reapprove their services with a given client. In future, the internal rotation with an increase in the cooling off period by 1 year is to be accompanied by an external rotation after 10 years with a cooling off period of 4 years. The client may request for a two-year extension of the audit mandate in exceptional cases. In case of a joint audit, the rotation period is extended to 24 years, 20 years respectively by public announcement of the audit firms. In order to limit the transaction costs of a new auditor in case of a rotation, the leaving auditor is requested to prepare a hand-over report according to the regulation draft.

This article mainly deals with the results of empirical audit research regarding effects of rotation and combined audit and non-audit duties on accounting and audit quality because the EU audit reform is controversial. The assumption of a positive link between external rotation and separation of audit and consulting on the one hand and accounting respectively audit quality on the other hand has to be questioned. We try to present a sound theoretical background of audit independence as well as a proper review of empirical audit research. Chapter 1 contains an agency theoretical foundation of rotation and the interdiction of combined audit and non-audit duties. In the next step, the controversial empirical audit studies are presented in chapter 2. Chapter 3 summarizes the results and gives a future outlook.

1. Theoretical foundation

1.1. Low balling

The traditional agency models neglect auditor changes (Ewert, 2003, p. 535). The risks of an asymmetrical distribution of information in audits can be magnified through the low balling phenomenon. Low balling indicates that the audit fees for the initial mandate as negotiated with the client do not cover the actual costs. This strategy can have a negative impact on auditor independence and can lead to higher incentives to form a coalition with the management (DeAngelo, 1981a). According to the basic model of DeAngelo (1981a), the first audit will cause start up costs because the auditor will have to familiarize himself with the business activities and environment of the company first (empirical evidence e.g. Ridyard and De Bolle, 1992). Still, the auditor chooses a low balling strategy to crowd competitors out. These losses of the first audit represent a market entry barrier for competing auditor firms. The learning effects of the next audits, which reduce the audit costs, are stated empirically e.g. by Rubin (1988) and Roberts and Glezen (1990). These information and cost advantages are an additional market entry barrier in later audit cycles.

Fee cutting, which implies a continuous increase of auditor fees through strategic market considerations has a positive effect on quasi rents and strengthens the incentives for low balling. A lack of fee cutting, however, does not necessarily mean that a low balling strategy was not utilized. Reversely, the presence of fee cutting is not necessarily evidence of a low balling strategy. At first, fee cutting could not empirically be proven (Palmrose, 1982; 1986, Rubin, 1985, Simunic, 1980). Since the late 1980s the evidence for this point increased (e.g. Ettredge and Greenberg, 1990, Turpen, 1990, Gregory and Collier, 1996 and Craswell and Francis, 1999). In recent years, fee cutting is less attractive for audit firms with regard to mandatory declarations in the notes and in the transparency report of audit firms. Audit fee reporting enables the identification of fee cutting by the investors. But to measure low balling is more difficult in general, since the self costs of audit firms in the initial audit are not reconstructible for clients (Simons, 2011, p. 162). Schatzberg (1990), Schatzberg and Sevcik (1994) and Schatzberg et al. (1996) had found evidence of low balling through experiments, only.

Based upon De Angelo's basic model (1981a), Beck et al. (1988) concentrate on combining audit and consulting services. Non-audit duties can lead an increased low balling effect when the auditor evaluates the financial accounting at the same time due to spillover effects. The economic advantage of maintaining the auditing assignment due to positive transaction costs of the change is only incurring a restriction of independence if differences of opinion are of multi periodical nature, various types in the auditing industry regarding evaluation of accounting, the client is unable to distinguish the type of the auditor, and the auditor himself knows his type only after the election. Lee and Gu (1998) argue that auditor independence can be increased by low balling if the auditor receives his assignment directly from the shareholders and not from the audit committee. In this scenario, quasi rents are a security deposit, which is immediately withdrawn if malperformance occurs. Although the auditor is elected by the shareholders, the assignment is awarded by the audit committee. Following Lee and Gu (1998), an accordingly positive effect of low balling only occurs if the supervisory board acts on behalf of the shareholders at all times, is independent from the management, and possesses appropriate financial expertise. A long-term assignment is equally necessary in order to extend quasi rents, upon which a re-election of the auditor is to be expected. From a German point of view there is normative restriction based on the auditor's internal rotation cycle and the necessity of annual re-election.

1.2. Impacts of the audit reform measures on accounting and audit quality

Rotation and separation of audit and non-audit duties can enhance accounting quality due to the prevention of auditor dependence. The necessity of a statutory rotation is solely related to large management operated corporations, because traditional agency conflicts are characteristic in this group. Shareholders in small and medium-size companies have greater influence on the management than an average private shareholder in a public company.

According to DeAngelo (1981a), quasi-rents according to low balling can lead to higher financial incentives to give up the independence of the auditor, if the probability of exposure by the investors is low. Insofar, low balling which is connected with a lack of independence can be prevented by rotation and concentrating on audit duties (Ewert, 2003, p. 536). Chi et al. (2004) refuse this opinion and state an adverse effect on independence under the existence of quasi rents and assignment by the owners. It is pointed out that the auditor would give up his independence in the last audit period before the rotation because he assumes hidden transfers of the management since he no longer has to be concerned about the loss of quasi rents due to shareholders not being re-elected.

Finally, literature assumes stricter audits under rotation and by concentrating on audit duties, because the auditor intents to diminish the risk of having his successor complain about his low performing upon review of previous years' audits (Ewert, 2003, p. 536). The avoidance of organizational blindness is pointed out, as negatively influencing the audit efficiency, even under observation of independence. Hence, the auditor simply trusts his results from previous years instead of anticipating important changes in the company development and adjusting his auditing strategy.

The advantages of these reform measures with regard to low balling are not secured because of system immanent disadvantages (Ewert, 2003, p. 536). An auditor change and the interdiction of non-audit activities incurs higher audit costs and audit fees which result in additional costs of the audit and transaction costs for the management. Especially long-term audit scheduling and following up on complaints or auditors' suggestions from previous audit periods would have to suffer under rotation and pure audit firms. US studies show that the auditor's risk of liability is significantly higher in first or second audits than in the following periods (AICPA, 1992. Since first audits tend to be of lower quality, negative responses of the capital market are to be expected upon a forced change of auditor and an interdiction of consulting.

Another important disadvantage of the reform measures is audit market concentration. Few big audit firms dominate the European audit market for listed companies. According to De Angelo (1981b), having the highest experience value in audit capital market oriented enterprises, they are related to a higher quality and independence, and have an extensive potential to offer a range of additional services. This oligopolization of the European audit market crowds smaller audit firms out of the market. Compulsory rotation and audit firms without non-audit activities cannot prevent these difficulties, since changes are made between big audit companies (external rotation) and small and medium sized audit firms do not have the relevant resources for consulting global companies.

The overall impact of compulsory rotation and the interdiction of audit and non audit duties is, from a theoretical point of view, not explicit, therefore, even with the auditor applying low balling, the reform measures do not necessarily imply higher quality but the interruption or shortfall of learning and experience effects can have an altogether negative effect on the quality of financial accounting and audit.

2. State of the art analysis of the empirical audit research results

2.1. Surrogates of accounting and audit quality

In addition to his professional knowledge, auditor independence is the most important indicator for the capital market to ensure appropriate quality of accounting and audit. Therefore the auditor's real independence does not suffice, but the capital market is to be convinced as well. Positive signals must be set, e.g. by legislating entities, showing that the principle of independence is observed and an appropriate quality of accounting and audit is guaranteed. Empirical audit research on possible negative impact on the independence and thus lower quality of accounting and audit due to counseling services and external rotation has gained significance especially in the jurisdictions of the U.S., Asia, and Australia (Schneider et al., 2006). In contrast, there are only a few studies on Continental Europe. The quality of accounting and audit is measured by values which, when considered separately, present a parameter with limited expressiveness. The following parameters are the most frequently used to evaluate the quality of accounting and auditing: earnings management, restatements, market reactions and going concern opinions. Therefore a study will have to establish whether an auditor's combined audit and counseling and no external rotation will negatively affect his independence and thus his judgment.

2.2. Combination of audit and non-audit duties

Simunic (1977) empirically establishes in his research of 263 U.S. corporations in the business year of 1977, regarding the demand of counseling services, that there is a positive connection between audit fees (AF) and non-audit fees (NAF) and concludes that there is a demand for flexibility in pricing.

Whether this shows an audit company's general pricing policy or the management significantly influences auditing fees is debatable. The positive connection between AF and NAF are confirmed over time, amongst others by Barkess and Simnett (1994) in 2,094 Australian companies between 1986 and 1990. According to Davis et al. (1993) who interview 98 U.S. corporations in 1993, there exists a positive connection between extent of the audit, AF and NAF. These findings seem to be consistent with the audited company as well as the auditing company. Parkash and Venable (1993) are able to establish a negative connection between recurring counseling activities and the extent of agency conflicts (differences of opinion between the auditor and the audited company) and an increasing demand for recurring counseling services in case of industry specialists in 860 U.S. corporations within the time frame between 1978 and 1980. The reason for this might be based on an enhanced flow of information between management and auditor/counselor, which reduces previous informational asymmetries.

In empirical studies, the effects of non-audits on the quality of accounting are often measured based on earnings management, which shows a certain density of research from a national as well as an international point of view. Earnings management is estimated based on discretional accruals (DA). The best-known models were created by Jones (1991), Dechow et al. (2003), Kothari et al. (2005) and Dechow and Dichev (2002). According to Alcarria Jaime and de Albornoz Noguer (2004), the performance adjusted model by Jones (1991) and Dechow and Dichev (2002) produce the most expressive results. The other models are of limited significance due to their assuming unaltering procedures within corporations (static approach).

An offensive earnings management tends to be rated negatively by investors, the reason being an encouragement of informational asymmetries between management and investors in order to consciously mask the actual economic situation or to shape them to fit specified goals for self-image reasons. In a thorough and independent review, the auditor will approach offensive claims of leeway in accounting policy more critically and will not accept questionable practices. Since the risk of coalition between management and auditor grows with increasing quasi-rents from audit and counseling assignments, the following studies aim to learn to what extent a possible restriction of the auditor's independence due to combined audit and counseling assignments is related to a larger extent of accounting policy. This would provide incentives to the management for using accounting political procedures more offensively if the auditor, due to counseling assignments, has become more dependent from the company and approaches the management less critically.

Previous empirical studies provide diversified results. Empirical studies which prove deteriorating quality of accounting due to increased NAF have mostly been published in the U.S. (Frankel et al., 2002; Ashbaugh et al., 2003; Kelley et al., 2004; in parts Larcker and Richardson, 2005; in parts Reynolds et al., 2004; Farag, 2005, in parts Dee et al., 2006; Dickins, 2007; Hoitash et al., 2007; in parts Huang et al., 2007; Srinidhi and Gul, 2007; Lai, 2007). Furthermore, negative effects of an auditor's combined audit and non audit services on the quality of accounting in the U.K. (Gore et al., 2001; Ferguson et al., 2004).

The survey of Gore et al. (2001) which interview 4.779, 4.765 and 2.435 U.K. corporations between 1992 and 1998 show a positive connection between NAF with auditors outside of the Big Five and earnings management. Likewise, Frankel et al. (2002), who study 2.472 intermediate reports in the U.S. for 2001 establish a positive connection between the counseling assignment and earnings management. Vice versa, however, the AF imposes a significantly negative effect on earnings management. Also, shortly after disclosure of the AF the capital market is proven to respond negatively (shrinking market capitalization). The following survey by Ashbaugh et al. (2003) in 3.074 corporations in the business year of 2001 consistently deduce a positive connection between NAF (relative) and earnings management. The authors even prove a negative connection between the NAF's relation to total fees (TF) and the negative accruals while there is no connection shown with positive accruals. In 610 U.K. corporations between 1996 and 1998, Ferguson et al. (2004) also see a positive effect of NAF and AF as well as the extent of counseling on the earnings management. A positive connection between the relation of NAF to TF and negative accruals is outlined by Kelley et al. (2004) for the U.S. capital market between 1995 and 2001. Larcker and Richardson (2004), who inlude 5.103 companies of the U.S. capital market in the business years of 2000 and 2001, prove a positive connection between the auditor's counseling assignment in significantly growing companies and the earnings management. In small and medium size growing companies in certain industries, Reynolds et al. (2004) detect a positive effect of NAF on earnings management in 2.507 U.S. companies in 2001. According to Farag (2005), in 1.500 U.S. corporations between 2000 and 2002, there is a positive connection between the accountant's counseling allotment, mainly in companies with consistent annual surplus, and earnings management. Dee et al. (2006) confirm this for 274 US companies in 2001 regarding the NAF, Coulton et al. (2007) for 4.021 Australian companies between 1993 and 2000 regarding the relationship between NAF and AF, AF/TF and positive accruals. Dickins (2007) (1.325 U.S. companies in 2000 and 2004), Srinidhi and Gul (2007) (4.282 U.S. companies in 2000 and 2001), and Lai (2007) (2.389 U.S. companies in 2002 and 2004) state a positive effect of the counseling assignment on the earnings management, while Hoitash et al. (2007) only measure relevant correlations within the time frame before the Sarbanes Oxley Act in 13.860 U.S. companies between 2000 and 2003. Huang et al. (2007) establish a more detailed differentiation of the non-audit assignments, studying 2.389 U.S. companies in 2003 and 2004. They find positive connections between tax consulting fees and negative accruals as well as between various other counseling services and positive accruals.

In their survey, Huang et al. (2007) see a difference between positive and negative discretionary accruals. While positive accruals are viewed critically and as a display of the management's self-image, high quality of auditing is granted to negative accruals since the latter are assumed to be avoided by capital market oriented corporations. In the 13.860 U.S. surveys in the business years of 2003 and 2004, no connections between the allotments of accounting related services and the earnings management could be established. Tax consulting services, however, provide a positive relation to the extent of negative accruals, which increases the quality of auditing as assumed.

Chung and Kallapur (2003) analyze 1.871 capital market oriented U.S. companies for the business year of 2001 without being able to establish an influence of NAF and the extent of counseling activities on earnings management. The same applies to Larcker and Richardson (2004) in cases where TF or NAF were marked as a variable based on the total sales per branch. Likewise, Reynolds et al. (2004) and Dee et al. (2006) are not able to find an impact where the extent of counseling services was involved instead of NAF. According to Ruddock et al. (2006), the same applies to 3.746 Australian companies during the business years of 1993-2000, for absolute and relative NAF as well as for NAF/AF. Also, according to Gul et al. (2007), in 4.720 U.S. studies in the business years of 2000 and 2001, no effects of NAF and the fee rate on earnings management are found. The same is true in 193 French companies between 2002 and 2004 according to LeMaux (2007), in 71 U.S. companies in 2001 according to Mitra (2007), in 235 New Zealand companies between 1995 and 2001.

Unlike the previously mentioned surveys, Antle et al. (2006) prove an opposite interdependency within the British and U.S. capital market between 1994 and 2000 (2.294 (U.K.) and 1.570 (U.S.) observations). According to them, AF is connected to higher earnings management and therefore lower quality of accounting and vice versa. Furthermore, a positive connection between AF and NAF is empirically founded and explained as spillovers.

Restatements, which are not consistent with the management's forecasts may cause negative market responses if participants in the capital market assume lower quality of accounting. In this context restatements are considered to be the cause of informational asymmetries between management and shareholders, which were previously used to the detriment of the general assembly. Based on the agency theory, an independent auditor can provide incentives, thus encouraging more thorough creation of accounting documents, which will make restatements expendable. Therefore, in the opinion of the capital market, restatements may be connected to low quality accomplishment of an account caused by dependency on a client through non-audit performance. Compared to other surrogates of the quality of accounting and audit (earnings management and going concern opinions) there have not been many studies on the evaluation of restatements and market reactions. Regarding restatements as a variable of accounting quality, the empirical studies by Raghunandan et al. (2003) in 110 U.S. companies in 2000 and 2001, by Kinney et al. (2004) in 432 U.S. companies between 1995 and 2000, and by Agrawal and Chadha (2005) in 159 U.S. companies in 2000 and 2001 do not show any significant connections between the NAF and restatements.

Furthermore, Ashbaugh et al. (2003), Raghunandan (2003), Francis and Ke (2006) and Khurana and Raman (2006) research market responses to auditors' combining audit and counseling services in the U.S. capital market. Although Ashbaugh et al. (2003), based on the business year of 2001 for 3,074 companies, state a positive connection between AF and NAF in companies with financial shortages, no impact of NAF/TF on market response can be detected, whereas Raghunandan (2003) points out, after surveying 172 Fortune 1000 corporations in the business year of 2001, that along with increasing NAF the shareholders increasingly contest the auditing results. Francis and Ke (2006) who research on 3,133 companies between 1999 and 2002 see a negative connection between the NAF and the earnings response coefficient, which reflects a change in the stock market value. According to them, more trust is placed in earnings surprises in case the NAF decrease. Also Khurana and Kim (2006) find an increasing connection between NAF and TF to be viewed negatively by the investors, based on 846 and 1,317 surveyed companies in 2000 and 2001.

Within an audit, the going concern premise is to be observed in order to determine to what extent the principle of going concern will be valid in the following business year. The going concern premise is to be rejected if opposed by factual or legal circumstances. Legal circumstances, which cause the bankruptcy and liquidation of the corporation are, for instance, pending insolvency proceedings or legal requirements and regulations, also expired patent, license, rent, or lease contracts, permissions and environmental constraints as well as modified legal conditions. Economic shortages, which will most probably force a company to cease business or sell assets outside of their usual business activities, are seen as circumstances opposing the going concern principle. On the other hand, financial problems can cause a company to discard the going concern principle, provided that a responsible management resolves upon termination without legal obligation. Indicators, which justify doubts in going concern by the auditor, are, amongst others, financial aspects (negative cash flows), operational aspects (loss of key market), and other issues (such as pending lawsuits).

After signaling, the management aims to obtain unrestricted approval according to their positive self-portrayal, since a restriction or denial would incur a negative signaling function in the capital market and, in consequence, might be sanctioned by withdrawal of capital or higher capital costs. Therefore, the management aims to meet the expectations of the capital market regarding the financial status of the company and to maintain confidence in the flawlessness of accounting and to avoid disappointments. The agency theory assumption suggests that a restriction of independence, e.g. due to combined counseling and auditing services by the auditor, the probability of an auditor providing a more favorable judgment and an unrestricted approval becomes obvious. However, a negative connection between non-audit fees and the refusal of unrestricted approval, which, based on these previous explanations, is very likely, can only be empirically comprehended in a few cases. Wines (1994), Sharma and Sidhu (2001) as well as Ye et al. (2006) provide empirical evidence for the Australian capital market. While Wines (1994) interviews 76 companies about the time frame of 1986-1990, Sharma and Sidhu (2001) focus on 49 companies between 1989 and 1996. Considering the low number, however, the significance of these two studies is limited. Carson and Simnett (2006) survey 709 companies, but only based on one business period (business year of 2002). Regarding the British capital market, Firth (2002) as well as Basioudis et al. (2008) submitted papers that suggest a negative connection between NAF and the restriction of going concern approvals. Accordingly, Firth (2002) is able to detect a negative impact on audit quality in 1.112 companies in 1996 based on counseling as a remarkable share on the auditing company's total revenue. Based on 58 companies in 2003, Basioudis et al. (2008) prove that the probability of restricted going concern opinions rises with increasing AF. Due to the time frame of only one period, the limited significance of the studies quoted here is to be pointed out. So far there is only one survey by Robinson (2008) regarding the U.S. capital market based on 2.009 companies between 2001 and 2004. It notes a negative effect of NAF on the quality of auditing only in case of tax consulting.

The empirical research available so far frequently leads to ambiguous results due to the fact that links between NAF and the auditor's testate cannot be proved. This applies to Australia (Barkess and Simnett, 1994; Craswell et al., 2002), the U.S. (DeFond et al., 2002; Geiger and Rama, 2003; Callaghan et al., 2009; Chan, 2009), New Zealand (Hay et al., 2006) and Norway (Hope and Langli, 2007). Barkess and Simnett (1994) fail to find proof in 2.094 Australian companies in the business years of 1986-1990, likewise Craswell et al. (2002) in 1.062 or 1.945 companies in the business years of 1994 and 1996, DeFond et al. (2002) who research 1.158 U.S. companies in 2001, Geiger and Rama (2003) in 132 companies in 2000 and 2001, Callaghan et al. (2009) who survey 92 bankrupt companies over the duration of 2001-05, and Chan (2009) in 1.681 or 1.780 companies from 2001-2003. Hay et al. (2006) analyze the business years of 1999-2001 for 177, 224 and 243 New Zealand companies and are equally unable to establish measurable connections between NAF and audit quality. Hope and Langli (2007) who include 12.281 companies in the Norwegian capital market in 2000 and 2001 are not able to note an impact of NAF, AF and TF on the judgment of auditors.

As previously mentioned, combined audit and counseling services theoretically concur with a lower independence of the accountant due to, for instance, financial dependence on additional services. On the other hand, due to higher synergy effects between counseling and auditing activities, according to the transaction cost theory there may be positive effects on the quality of auditing, along with the auditor's deeper knowledge of company matters. In this respect, some empirical studies on the capital market in the U.S. (Lennox, 1999; Lai and Yim, 2002; Lim and Tan, 2008) and Australia (Fargher and Jiang, 2007) prove positive effects of increasing counseling services on the limitation of going concern opinions. However, Lennox (1999) only note slightly significant results in 2,244 corporations between 1988 and 1994. Lai and Yim (2002) who interview 2.099 companies in 2000, a positive impact is only detected in the first audit period. Likewise, the positive connection noted by Lim and Tan (2008) in 1.692 companies in 2000 and 2001 only apply to specialized auditors. No connections are found for non-specialized auditors. In 1.769 and 3.344 companies in 1998 and 1999, Fargher and Jiang (2007) restrict a positive connection to NAF/TF, however not to NAF. We may conclude that there are mainly ambiguous results regarding the impact of counseling services by the auditors on the quality of auditing, operationalized by going concern audit opinions.

2.3. External rotation

The following empirical surveys on external rotation mainly relate to the US capital market. Based on an experimental US-study, Dopuch et al. (2001) stress that in case of audit without external rotation it is more likely that the auditor over time biases approval testates accommodating the management, and conceals errors from the public. In that experiment, however, experience effects of the auditor under a long-term assignment remain uncovered. Boone et al. (2008) point out signs of interdependence between external auditor rotation and risk margin on allocated capital contribution in 12,493 surveys on the US capital market during the business years of 1974 – 2001. Capital costs decrease in the first years of the assignment and rise with its duration. Finally, based on 12,892 US corporations in the business years of 1991 – 1998, Davis et al. (2009) state that the management takes advantage of its leeway in decisions and arrangements in short (two to three years) and very long duration of assignment (at least thirteen years) in order to fulfill or outdo result prognoses. The latter is considered positive by the capital market and may reflect in a higher demand of shares. So, the duration of the audit assignment has a positive effect on the extent of maximum earnings management, so that audit quality is increased by external rotation after a longer duration.

Recent studies mainly do not document a tendency of weakening the quality of accounting and auditing due to external rotation. Comparatively short assignments (2 – 3 years) cause higher training costs combined with a lower quality of accounting (Johnson et al., 2002). They concentrate on 11,148 US surveys during the business years of 1986 – 1995, while no lower quality in long-term assignments (at least nine years) occurs. Auditors in long-term assignments (more than five years) disapprove of a maximum accounting policy due to learning and experience effects (Myers et al., 2003) in 42,302 US corporations between 1988 and 2000. Al-Thuneibat et al. (2011) state a negative correlation between external rotation and the quality of accounting in 358 Jordan companies listed at the stock exchange between 2002 and 2006. In a survey of 35,826 – 38,794 US corporations between 1990 and 2000, Ghosh and Moon (2005) show that investors, rating agencies and analysts assume positive interdependence between the duration of assignment and the quality of accounting, represented by the interest rate investors require, rating results, as well as the analysts' performance prognoses. Contrary to their results with US students on internal rotation, Gates et al. (2007) show that investors' confidence in the financial accounting quality in a regulatory environment with increased Corporate Governance methods cannot be influenced by external auditor rotation. Furthermore, according to Carcello and Nagy (2004) based on the business years of 1990 – 2001, 267 US corporations showed balance manipulations mostly in the first three years of the assignment, since the management assumes lower quality of audit provided by new auditors. A long-term assignment (at least nine years), however, does not imply a significant increase of balance manipulations.

Rotation can lead to negative capital market responses in the assessment of stocks of risk intensive companies (Mansi et al., 2004, based on 8,529 US surveys between 1974 and 1998). Therefore, with greater entrepreneurial risk, investors tend to rate the auditor's learning and experience effects in a long-term audit assignment higher than possible limitations of his independence. Independence in appearance of the capital market does not decrease with extended assignments (Knechel and Vanstraelen (2007), based on 618 Belgian companies for the business years of 1992 – 1996). Azizkhani et al. (2007) see the duration of assignment in 2,033 Australian companies between 1995 and 2005.There are no significant changes in capital costs under external rotation. Fargher et al. (2008) compare the impact of internal and external rotation on 590 Australian companies during the business years of 1990 – 2004. In the first years after an auditor change (internal rotation) the management lowers the extent of accounting policy. Under external rotation, however, a significant increase of discretionary periodical classification is established.

Furthermore, the probability of restrictions in going concern opinions are lower in the first years of the assignment based on a higher reporting error rate of the auditor (Geiger and Raghunandan (2002), based on 117 US Corporations with significant liquidity issues between 1996 and 1998; Jackson et al. (2008) based on 1,750 companies in the Australian capital market between 1995 and 2003). Interdependences between the duration of assignment and the quality of financial accounting cannot be established, so that the necessity of external rotation is ultimately dismissed (Jackson et al. (2008)). In the case of the Spanish audit market, based on 1,326 companies with significant liquidity issues in the business years of 1991 – 2000, Ruiz-Barbadillo et al. (2009) are not able to prove empirically that an external auditor change increases the probability of restricted going concern opinions.

3. Summary

The external auditor must be independent from management in order to ensure appropriate financial accounting and audit quality. This basic requirement includes independence in fact and independence in appearance (by the investors). Based on the principal agent theory, auditor independence reduces the probability of his collaborating with management against the company's target groups by having his impartiality compromised, thus filing unfounded reports. Internal and external rotation of the auditor might strengthen his independence. While only internal rotation was mandatory yet, the current European audit regulation contains a mandatory external rotation and a separation of combined audit and non-audit duties. But the link between these reforms and accounting respectively audit quality is controversial. Insofar, the aim of the analysis was to evaluate the principal agency theory and recent results of empirical audit research. Increased auditor independence will not necessarily be reached by rotation rules and by prohibiting consulting services due to lower learning and experience effects. The total effect on accounting and audit quality can be negative even under low balling. Empirical studies show that accounting and audit quality might not increase.

Finally, there are some research limitations. The empirical audit research is dominant on the US, Asian and Australian capital market. Only few studies dwell on EU member states (Italy, Germany, Belgium, and Spain). Then, the proxies for estimating accounting and audit quality (e.g. discretionary accruals, restriction of going concern opinions) have a limited value. Insofar the European standard setter should perform cross-national empirical studies before a huge intervention of the European audit market.

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