

Audit firm independence safeguards for the revolving door practice

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ABSTRACT

Audit firms have a responsibility to establish a quality control system of policies and procedures designed to create and maintain independence. This study investigates the extent to which audit firm safeguards within the system protect independence in appearance and perceived audit quality when a nonpublic client audit engagement involves the revolving door practice, which is where an auditor leaves an audit firm to join one of the audit firm's clients. Examination of safeguard effectiveness occurs through a national sample of commercial bank loan officers who respond to a between-subject design (BSD) case experiment. The BSD experiment manipulates the following three safeguards: (1) the current AICPA guidance for nonpublic clients, (2) the current AICPA guidance plus a mandatory peer review requirement, and (3) the current AICPA guidance plus a mandatory cooling-off period requirement. The BSD experiment results do not indicate a statistically significant difference between safeguards for maintaining independence or audit quality.

Keywords: auditor independence, cooling-off period, revolving door practice, client employment, safeguards

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INTRODUCTION

The accounting profession through the American Institute of Certified Public Accountants (AICPA) is responsible for establishing the standards/requirements regarding private company audits. The effective fulfillment of this responsibility by Certified Public Accountants (CPAs) is critical to maintaining public trust in the accounting profession and CPA services. Public confidence in attest services is enhanced by requiring audit firms to be independent of those for whom the service is provided. As such, audit firms have the responsibility to implement policies and procedures designed to create and maintain independence. However, the Code of Professional Conduct of the AICPA recognizes that independence can be threatened (AICPA 2017a, 1.210.010). Often this threat results from a relationship that a firm may have with a client.

One relationship form with the potential to cause a threat to independence is the hiring of an audit firm's employee by one of the firm's audit clients (AICPA 2017a, 1.279.020). This client employment relationship is often referred to as the "revolving door practice" (Clikeman 1998, Geiger et al. 2008). The revolving door practice situation considered in this study involves the ex-auditor having been an AICPA covered member of the client audit engagement team who has taken a key position in financial reporting with the client (AICPA 2017a, 0.400). Such employment by a client has been identified as a potential threat to independence through two concerns (Beasley et al. 2000). One concern is the possibility that the client company will not provide quality financial reporting. The second is an increased possibility that accounting irregularities would go undetected by the audit firm. These issues may develop from a possible lack of professional skepticism as remaining audit team members place too much confidence in decisions of the ex-auditor to the ex-auditor's possible ability to circumvent the audit plan used by the firm. Research corresponding to these compromised independence concerns include Imhoff (1978), Menon and Willams (2004) and Wright and Booker (2010). However, research by Geiger et al. (2005), Sori and Mohamad (2008), and Geiger et al. (2008) indicates that the revolving door practice does not negatively affect independence.

Should the client employment relationship compromise professional judgment or indicate circumstances perceived as inhibiting proper judgment, it would impair independence and hence prevent an audit firm from conducting an audit in accordance with generally accepted auditing standards for that client (AICPA 2017a, 1.200.001). To avoid impaired independence due to a firm relationship, audit firms work within the parameters of the requirements related to the client being a public (SEC reporting) or nonpublic (private) entity. Interestingly, current requirements regarding the hiring of an audit firm's employee by an audit client differs for audits of public versus nonpublic entities. The requirement for public clients is more stringent requiring a one year cooling-off period (absence from participation on the client audit engagement) for auditors taking financial reporting roles at audit clients (U.S. e-CFR 2017). Thus, the possibility exists that those who rely on audit opinions for nonpublic companies may not be as protected from this form of independence threat. However, contrary to assuming the corrective procedure is a cascading of the requirements for public clients to the nonpublic setting, it is appropriate to consider potential options to safeguard from this threat.

A literature review on safeguard¹ options identifies a time lag or “cooling-off” type time period as the primary empirically evaluated safeguard option in the public and nonpublic company setting. Other potential safeguard options to evaluate with respect to the revolving door practice include items such as indicating that a firm follows the five criteria² in the current AICPA guidelines for nonpublic company audits and requiring completed audits involving the revolving door practice to be mandatorily selected for inclusion in a firm’s peer review process similar to the current requirement placed on audit firms completing audits of large depository institutions.^{3,4}

Continuing research on the revolving door practice is merited by the importance of independence, mixed research results on the topic, different requirements for public and nonpublic audit clients, and the existence of multiple safeguard options. Therefore, the study investigates whether the current independence requirements regarding audits of nonpublic companies are sufficient, or whether independence in appearance is not addressed sufficiently and new requirements are necessary for enhancing perceived firm independence and audit quality. The study offers and evaluates safeguard options available to the profession for addressing the revolving door practice with a between-subject design (BSD) case experiment. Commercial bank loan officers offer their opinion on the effectiveness of the safeguards.

The remainder of this paper is organized into four sections. First is a discussion of the prior literature on the subject. The second section provides information on methodology. The third section covers the results of the study and the last section provides study conclusions, limitations, and future research options.

LITERATURE REVIEW AND HYPOTHESES

The revolving door practice was first examined by Imhoff (1978). The study evaluates audit firm independence under various hiring situations through a survey administered to CPAs, financial analysts, and bank loan officers. The research concludes that independence is more negatively affected when an auditor held an upper level or supervisory role rather than a non-supervisory role. The research also indicates that the inclusion of a time lag (cooling-off period) between participating in client audit work and hiring by the client company aids in maintaining independence. Koh and Mahathevan (1993) advance research on the topic in a study of company managers located in Singapore by adding a variable for the position accepted at the client company. Their research indicates that perceptions of independence are questioned more with a

¹ Safeguards are controls/actions that mitigate or eliminate threats to independence (AICPA 2017a, 0.400).

² Basic criteria: establishing the former employee has no continuing financial or operational relationship with the audit firm, consideration should be given to modify the general audit plan, ensure a competently staffed engagement team, and provide for an internal review of the audit that checks for maintenance of professional skepticism during the audit process (AICPA 2017a, 1.279.020).

³ Standards for a firm’s quality control process require that an audit firm having a depository institution client(s) that has over \$500 million in assets must include at least one of those audit engagements in the firm’s peer review (AICPA 2017b, 1045).

⁴ Peer review as a safeguard for client employment was mentioned in *Independence Standards Board Standard No. 3*, but it was not adopted nor empirically evaluated.

shorter cooling-off period (six months vs. thirty months) and for situations indicating the joint combination of the position held at the audit firm being supervisory and the accepted client position being in a financial reporting capacity. Wright and Booker (2010) examine the revolving door issue with state board of accountancy members based on the regulatory environment of a nonpublic company audit client. In this research, an audit manager leaves the audit firm to join the client as chief accounting officer under manipulations of the time frame for the cooling-off period.⁵ The findings indicate that perceptions of independence improve with a cooling-off period of one year or longer. Additionally, in the absence of a cooling-off period, state board members are less likely to approve of the audit firm performing an audit of the client. However, in a review of their research instrument, participants did not receive guidance on the regulation in place for an audit firm to follow in maintaining independence regarding the revolving door practice. These studies and others (Firth 1981; Ahmad 2015) that manipulate the conditions affecting the revolving door practice indicate the practice is a threat to independence; however other researchers have not found this threat.

A qualitative study by Sori and Mohamad (2008) with bank loan officers and company executives in Malaysia indicates minimal effect on independence from the revolving door practice. Geiger et al. (2005) and Geiger et al. (2008) use archival data to evaluate the effect of the revolving door practice in public company audit situations. Geiger et al. (2005) indicate that the accruals taken by companies with a revolving door situation are not significantly different from the accruals taken by other study group companies with no revolving door hire. Geiger et al. (2008) find a positive market reaction to the revolving door practice when examining cumulative abnormal returns around the hiring date and additionally find no association of lower quality financial reporting in companies with a revolving door hire. These studies and others (Dart and Chandler 2013; Wilson 2017) bring into question the threat posed to independence by the revolving door practice.

In summary, prior research indicates a general concern that the revolving door practice threatens the independence of the audit firm. In particular, independence is questioned when the former audit firm employee held a supervisory position at the firm and then takes a senior financial reporting position at the client. However, an additional relevant finding is the indication that implementing a cooling-off period of at least one year mitigates the threat.

The above considerations motivate the examination of potential safeguards for the revolving door practice in the nonpublic company setting. The following hypotheses (stated in the null form) allow examination of potential independence safeguard forms for their ability to reduce or eliminate the threat of impaired independence. The hypotheses address safeguard effectiveness toward independence in appearance of the audit firm, safeguard effectiveness for audit quality, and safeguard effectiveness to merit the firm the ability to continue to conduct the client audit.

- H1: There is no difference between the perceived effectiveness obtained with (1) the current AICPA guidance for maintaining independence for the revolving door practice and requiring the AICPA guidance plus (2) a mandatory peer review safeguard or (3) a mandatory cooling-off period safeguard for auditors of nonpublic companies.

⁵ In this article, Wright and Booker select a strict form of cooling-off implying disassociation from the audit firm while the SEC rule indicates disassociation from participation with the client's audit. See footnote 1 in the Wright and Booker article for more details.

- H2: There is no difference between the perceived effectiveness for audit quality obtained with (1) the current AICPA guidance on independence for the revolving door practice and requiring the AICPA guidance plus (2) a mandatory peer review safeguard or (3) a mandatory cooling-off period safeguard for auditors of nonpublic companies.
- H3: There is no difference between the perceived effectiveness to merit the allowance to audit in a revolving door practice situation obtained with (1) the current AICPA guidance and requiring the AICPA guidance plus (2) a mandatory peer review safeguard or (3) a mandatory cooling-off period safeguard for auditors of nonpublic companies.

METHODOLOGY

This research obtains information from commercial bank loan officers based on responses to a BSD case experiment. Research instruments were mailed to subjects as a packet. The packet contained a cover letter requesting participation and instructions for completing the research.

The BSD experiment offers case scenarios indicating that a nonpublic company, Best Value Company (BVC), is seeking a commercial bank loan to improve its facilities. BVC's loan application includes three years of audited financial reports completed by Focus CPA firm. The independence of Focus CPA firm is intended to be brought into question through BVC hiring an audit manager from Focus to a key position in financial reporting. Specifically, the audit manager was the BVC audit engagement manager over at least one of the audit report dates and became the BVC controller. The cases indicate Focus handles the client hiring by following actions that correspond to the potential safeguard options. After reading an assigned case, subjects respond to three questions concerning the confidence they would place in Focus's independence, audit quality, and allowance to audit.

A total of three separate mailings were sent to the subjects following procedures in Salant and Dillman (1994). All potential subjects received the first mailing, while additional mailings went to subjects who had not responded. Completed instruments were returned in a stamped, pre-addressed return envelope. The study design is further described in the following sections: (1) participants, (2) variables and data collection, and (3) statistical methods.

Participants

This study uses bank loan officers as a representative group of financial statement users of nonpublic company audited financial statements. A sample of 1,125 bank loan officers were randomly selected from a national database of over 26,000 U.S. bank executives. The bank loan officers were randomly assigned to one of three case versions for the BSD experiment.

Forty-six usable responses were received for the BSD experiment (4.1% response rate)⁶. Demographic characteristics of the participants' demonstrate the panel is informed about

⁶ Recent research indicates that mailed instruments have response rates ranging from 5% to 9% (Colbert et al. 2008; Rupley et al. 2011).

banking and the use of audits to aid in lending decisions. Eighty-nine percent of the respondents hold a college degree. Ninety-four percent of the respondents have ten or more years of general banking experience and 66 percent have ten or more years of commercial lending experience. Fifty-four percent of the respondents hold a senior vice president level position or president position. Seventy-six percent of the respondents have used audits in nonpublic lending decisions. Finally, 87 percent of the respondents are over 40 years of age.

Variables and Data Collection

The BSD experiment of the study uses one independent variable. The independent variable is representative of three safeguards for concerns about the potential impairment of audit firm independence. The safeguard forms are the only manipulation in the case scenarios. The first safeguard option is indicative of the firm following the current AICPA rules for nonpublic clients (referred to as “AICPA”). The second safeguard indicates the firm is subject to a mandatory peer review requirement combined with the current AICPA rules (referred to as “Peer Review” and thus implying an external compliance review regarding whether the firm follows the AICPA rules). The third safeguard indicates the firm has a mandatory one year lack of participation with the client engagement (the cooling-off period) requirement combined with the current AICPA rules (referred to as “Cooling-off” and thus is reflective of the current guidance for public company auditors where participation in the audit engagement of the client is not allowed for one reporting period prior to joining the client in a financial reporting oversight role).

AICPA guidelines suggest that multiple dependent variables be evaluated when considering independence (AICPA 1997). The variables should allow for analysis of: confidence in independence, reliability of financial statement data, and a discretionary decision of the financial statement user⁷. Therefore, three dependent variables are used to evaluate the experiment. The three dependent variables include: (1) confidence in independence, (2) confidence in audit quality, and (3) allowance to audit. Confidence variables are measured on an eleven-point Likert scale of zero (not confident) to ten (confident) and the allowance variable is measured “Yes” or “No.” Similar variables and scales are used in other similar type research studies (Lowe et al. 1999; Wright and Booker 2010).

Statistical Methods

The nonparametric Kruskal Wallis test is used to compare mean ranks for the three groups in the BSD experiment on the dependent variables of confidence in independence and audit quality. To evaluate the dichotomous choice (yes/no) on the dependent variable of allowance to audit, the multiple comparisons test of proportions is used. This test allows for pairwise comparisons of the “Yes” proportions on the discretionary decision to identify statistical significance between the safeguard options.

RESULTS

⁷ A discretionary decision requires respondents to provide a concrete answer such as a yes or no to a specific scenario.

The experimental results are summarized in Table 1 (Appendix). Question one on the case addresses hypothesis one (H1). Respondents consider the question: “How confident are you that Focus CPA firm is independent in performing the audit of BVC?” The Kruskal Wallis test reveals a test statistic of 3.42 and p-value of .181, therefore H1 cannot be rejected. The data do not provide enough evidence to suggest that the respondents consider one safeguard form to be more effective than the others at maintaining independence in appearance. The statistical analysis shows mean values for the options range from 6.44 for the “AICPA” safeguard to 7.48 for the “Cooling-off” safeguard. These mean values correspond with all the options providing the respondents with above moderate confidence in independence. The results suggest an order for the safeguard options of the “AICPA” to “Peer Review” to “Cooling-off.” Although statistical significance is not evident, the ordering is in line with a trend of increasing perception of independence.

The second case question addresses hypothesis two (H2). Respondents consider the question: “How confident are you that Focus CPA firm can provide a quality audit on BVC?” The Kruskal Wallis test reveals a test statistic of 1.92 and p-value of .383, therefore H2 cannot be rejected. The data do not provide enough evidence to suggest that the respondents perceive a difference in the audit quality that could be obtained from the different safeguards. The statistical analysis shows mean values for the options range from 6.44 to 7.57. These mean values correspond with all the options providing the respondents with above moderate confidence in the level of audit quality. The results suggest an order for the safeguard options of the “AICPA” to “Peer Review” to “Cooling-off.” The results align with the findings of nonsignificance on the independence analysis.

The final case question addresses hypothesis three (H3). Respondents consider the question: “Did Focus CPA firm have sufficient independence to have been allowed to conduct the audit?” The proportion tests reveal no statistical difference between any of the groups, therefore H3 cannot be rejected. The data do not provide enough evidence to suggest that the respondents perceive a difference in effectiveness between safeguard forms for independence. The statistical analysis shows that the proportion of respondents answering “Yes” ranges from 66.7 percent to 87.5 percent for the safeguard options. These proportions indicate all the options provide sufficient independence to allow the firm to conduct the audit. The proportional ranking from low to high for the safeguard options is the “AICPA” to “Cooling-off” to “Peer Review.” In agreement with the safeguard forms not significantly changing the perception of independence or audit quality, the allowance to audit analysis not identifying a statistically significant difference for the safeguard options is reasonable. Overall, the BSD experimental results indicate that the current AICPA requirement for nonpublic audits is acceptable, as would the imposition of the other possible requirements.

CONCLUSION, LIMITATIONS, AND FUTURE RESEARCH

The current study provides new insight on safeguards for audit firm independence and the revolving door practice with nonpublic audit clients. In the BSD experiment, loan officers give each safeguard option a similar confidence level rating for independence and audit quality and associate each safeguard with being effective for allowing continued conduct of the client audit. A major take away for regulators and accounting firms from the results is support that the current guidance is as effective as more stringent safeguards. While various safeguards are important

and influential to financial statement users the cost and true benefit gained from them must be carefully addressed.

The research results and conclusions of the study are subject to limitations. The study response rate is similar to other studies but not high. Low response rates can imply that nonresponse bias may impact the generalizability of the research. While it is not certain that nonresponse bias does not exist, the wave technique analysis (comparing early and late responders) does not indicate that this bias is an issue. A second limitation of the study is a lower pass rate on a manipulation check question for recognizing specific characteristics in the BSD experimental cases. The responses with manipulation check failures are concerning, but efforts were made in the creation and testing of the instrument to allow for the proper identification of each manipulated safeguard characteristic. Additionally, BSD experimental statistical results are presented without responses containing manipulation check failures. A third limitation of the study is the realism or reality of the revolving door practice and the audit firm response portrayed in the experimental cases and questionnaire. Informative real-world information is difficult to replicate in the limited setting of a case. However, due diligence taken in the creation of the instruments and adjustments incorporated from pretesting give the instruments a realistic perception. A final limitation of the study involves the use of only commercial bank loan officers. Therefore, the results may not be representative of other financial statement users.

While the current study provides new information on the benefits of safeguards for addressing the revolving door practice in the nonpublic company environment, a future study may address the costs associated with the CPA profession implementing new safeguards for independence. Cost considerations associated with a new study may include: regulation write-up and enforcement cost, the opportunity cost to audit firm clients as a consequence of not being allowed to hire directly from their current auditor, and the additional cost associated with record maintenance to comply with peer review standards. Research on this topic may include other subjects, such as state board of accountancy members, audit committee members, or CPAs evaluating the safeguard options for effectiveness regarding independence. Finally, future research may address different types of safeguards.

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APPENDIX

Table 1

BSD experiment summary of bank loan officers' perceptions of independence, audit quality, and decision to allow audit.

Groups	Independence ^a	Audit quality ^b	Percentage allowing audit ^c
AICPA	6.44 19.34 (2.07)	6.44 19.67 (2.88)	66.7%
Peer Review	6.75 20.94 (1.98)	7.25 22.03 (1.98)	87.5%
Inside	7.48 27.21 (1.89)	7.57 26.26 (1.94)	85.7%
Significance of overall differences across groups ^d	p = .181	p = .383	p > .10

^a Mean, mean rank, (standard deviation) of auditor independence in appearance is measured on a scale of 0 (not confident) to 10 (confident). Significance of the overall differences in mean ranks is assessed using the Kruskal Wallis test.

^b Mean, mean rank, (standard deviation) of perceptions of audit quality is measured on a scale of 0 (not confident) to 10 (confident). Significance of the overall differences in mean ranks is assessed using the Kruskal Wallis test.

^c Percentages correspond to participants that answer "yes" to allow audit verse not allow. Significance of the overall differences is assessed using the multiple comparisons test of proportions.

^d No pairwise comparisons occur since statistically nonsignificant differences are obtained for the overall group differences.