Impact of Mandatory Audit Firm Rotation: The Evidence from the UK

Abstract

The demise of Arthur Andersen and collapse of Enron, Polly Peck, Schlecker and other companies have resulted in serious repercussions on the public’s confidence of the value of the audit. Despite a growing stricter regulatory framework, financial scandals have continued to occur, and often involve the Big 4 accounting firms - PwC, EY, KPMG, and Deloitte. To maintain the audit quality, competition and to continue the culture of the independent audit, the European Union has introduced mandatory audit firm rotation (MAFR). This study aims to examine the early results of MAFR in the UK and explore its effectiveness using the three key measures - independence, quality and competition. FAME and Nexis financial database were used as a source of data and analysis. The FTSE350 firms are selected for analysis as they are the main target of the regulatory changes in the UK. We find no significant improvement in the high market concentration of the industry, implying that the proposed change in regulation has not achieved, as yet, its full usefulness to open up the market to mid-sized and small tier firms. Additionally, the results show a negative relationship between audit rotation and audit quality. We find the length of audit tenure has little or no effect on the extent of non-audit services provided by the auditor which is used as proxy for auditor independence. This also supports the view that future policy makers should re-consider ways of improving audit independence, competition and quality of the audit and thereby addressing the continuing concerns and enhancing the credibility of the audit industry.

Keywords: Audit rotation; Audit quality, Audit Independence; Audit firm competition