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RESEARCH ARTICLE / ARAŞTIRMA MAKALESİ

# Audit Quality and Rotation: Perception in Turkey

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**Abstract**

Independent auditors, who form an opinion on financial statements, increase the reliability of financial statements by minimizing the information risk. Investors, credit institutions and other users of financial statements are expected to increase the accuracy of their economic decisions by making use of these tables that are believed to be reliable. In order to achieve this aim, auditing activities must be carried out in a manner of high quality. One of the most important indicators of quality in auditing is the independence of the auditor. It is claimed that mandatory audit firm rotation is one of the indicators of independence in auditing. Past studies have reached varying conclusions regarding the impact of rotation on audit quality. In this study, it is aimed to measure the perception of the users of financial statements in Turkey about audit rotation on audit quality.

**Keywords**

Independent Audit, Audit Rotation, Audit Quality, Turkey

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# 1. Introduction

The credibility of independent auditors has been damaged many times due to accounting scandals in the past years. In this sense, regulations, standards and rules have been introduced in many countries in order to increase the independence of the auditor both in appearance and in reality, to regain public trust and thus to increase the audit quality.

Following the accounting and auditing scandals that took place in companies in the United States of America (USA) in the 2000s and spread throughout the world, the Sarbanes-Oxley Act, which was introduced in the USA in 2002 and implemented measures to protect investors. Within the scope of the regulation, important rules have been made in the audit of the financial statements of publicly traded enterprises. One of the most important of these rules is related to the necessity of audit rotation.

Rotation in auditing is seen as a process directly related to the auditor's independence, and as a way to increase audit quality in order to prevent the auditor's close relationship with client business personnel and management.

Regulations regarding rotations and periods in independent auditing are made by the Public Oversight Accounting and Auditing Standards Board (KGK) in Turkey. In Turkey, rotation of the independent audit firm and audit team is obligatory by the KGK.

The aim of this study is to compile information about mandatory firm rotation in independent auditing and to measure the effect of mandatory audit firm rotation in Turkey on perceived audit quality. The positive or negative effects of mandatory audit firm rotation on firms and financial institutions in Turkey have not yet been measured. It is hoped that the findings will be useful to independent audit companies, the KGK, the Banking Regulation and Supervision Agency (BDDK), the Capital Markets Board (CMB) and stakeholders benefiting from this service.

In the second part of the study, general information about quality and rotation in independent auditing is given. In the third section, past research examining the effect of rotation on audit quality is presented. In the fourth chapter, the results of the research measuring the effect of compulsory firm rotation on the perceived independent audit quality are given. In the conclusion part, the contribution of the study, its limitations and future research are stated.

## 2. Quality and Rotation On Independent Audit

Individuals who make economic decisions about a business are expected to benefit from the financial statements of that business. In order to distribute the existing financial resources in the most efficient way, it is important that independent audit activities are carried out in a manner of high quality. Investors and lenders of the business can be misled by an erroneous audit opinion. Another important purpose of independent auditing is to increase confidence in the market. For this reason, the financial statements prepared by the company's management should be carefully analyzed by the independent auditors and the results should be presented to the users of this information in the most accurate way (Goodwin ve Seow, 2002, s.42).

Although the necessity and importance of establishing a quality control system for the independent audit service to be of high quality was first expressed in the 1970s. Quality control gained great importance especially with the accounting scandals experienced in the 2000s. Quality control includes the activities that should be done not only at the end of the audit process, but also at all stages of the audit process, starting from customer acceptance (Altıntaş, 2007, s.38-39).

According to DeAngelo; the quality of audit services is defined as the probability that an auditor will both discover a breach in the client's accounting system and report the breach (DeAngelo, 1981, s.183-199). The likelihood of an auditor detecting a breach depends on the auditor's experience, the advanced background of the technology he uses to do his job, the audit procedures he performs, and the scope of sampling, etc.

If audit quality is measured empirically, it can be judged by looking at three situations: (Moizer, 1997, s.61-74).

- Whether the nature of the audit work performed and the amount of audit evidence collected are appropriate for the client entity;

- Whether the audit personnel who will undertake the work are technically competent,

- Whether the firm independently reports any errors or omissions it detects.

Mandatory audit rotation can be viewed in terms of audit team rotation and audit firm rotation. At this point, the purpose of rotation in auditing can be explained as preventing any situation that may cast a shadow over the independence of the person doing the job, and damage professional skepticism.

The regulation of mandatory audit firm rotation, which is one of the attempts to restore public confidence in restoring trust in audit firms and the quality of audit activity, is still under discussion among audit parties. Some interest groups state that mandatory audit firm rotation can ensure auditor independence, reduce the problem of intimacy with the client enterprise, and increase skepticism in the professional judgments of auditors (Davis, Soo, Trompeter, 2009, s.517-548). The American Accounting Association (AAA) has determined that some companies included in the Dow Jones 30 Index have worked with the same audit firm for more than 60 years. It has been argued that this situation destroys the professional skepticism that should be in the independent auditor (Forbes, 2018).

Others have predicted that there may be costs such as the turmoil caused by the audit firm selection processes that may be experienced during the audit rotation process, the increased prices that may be applied for the new contract, and the loss of time that may be caused by the process of getting used to a new audit firm (Catanach ve Walker, 1999, s.61)

These assumptions suggest that there is still a lack of consensus between advocates who see the effects of mandatory audit firm rotation as a solution and the opponent, who see it as a limitation to efforts to improve the quality of audit service.

It can be said that the application of compulsory rotation in the audit aims to look at the financial statements and general accounting process from a different perspective during the execution of the audit activities, and at the same time to ensure the full independence of the auditor (Daugherty, Dickins, Hatfield ve Hickins, 2012, s.98).

The International Ethics Standards Board for Accountants (IESBA), which operates under IFAC, has published a guide called "Ethical Rules for Accountants". In this guide, it is stated that working with the same audit personnel for a long time with the same client company while an audit activity is being carried out may cause intimacy, which may adversely affect the independence of the auditor, and it has been suggested that it would be appropriate to apply rotations at 7-year intervals to the audit team.

With the mandatory rotation practice in auditing, businesses are looking for new auditors, thus increasing the competition in terms of quality among audit firms, and also enabling small-scale audit firms to acquire new customers (Raiborn, Schorg ve Massoud, 2006, s.40).

Audit independence can be expressed as independence of mind, that is, independence in reality and independence in appearance. The former indicates that the auditor has an independent mindset when planning and executing an audit activity, while the latter simply appears to be independent (Dopuch, King ve Schwartz, 2003, s.79-114). These two different situations may be affected by the long-term relationship that exists between the auditor and the client entity. In this sense, mandatory audit rotation can prevent the closeness and intimacy that may occur between the audit team in the independent audit firm and the client business personnel, thus strengthening independence.

As auditors spend extended periods of time with client business employees, they may begin to unconsciously feel part of the client business and lose their objective view of assessing the transparency and reliability of their accounts. A long-term relationship between the auditor and the client business can reduce investors' confidence in the figures presented in the financial statements. In this sense, mandatory rotation may increase the perception of the auditor's independence for financial statement users. As Turner, a former Chief Accountant of the American Securities and Exchange

Commission (SEC), put it at a conference on independence: "auditor independence is really about one thing; investor confidence in numbers" (Turner, 2000).

Another great benefit of mandatory rotation in inspection comes from the phenomenon described as "new fresh look" or "new fresh eyes" (Shockley, 1981, s.785-800). If the auditor carries out the audit service in the same client business for a long time, it can become a kind of professional routine. Certain accounting policies or repetitive circumstances that were deemed "correct" in previous audits may be omitted without re-examination based on prior audit testing, and thus potentially result in material errors and misstatements. However, when a new audit firm arrives, it may approach the client's financial statements with a "new" critical eye and continue to review each phase of the audit with greater attention and motivation. It can reduce possible errors and increase the audit quality by providing a different perspective on recurring audit work and reporting every period.

Mandatory audit firm rotation may also result in the end of economic dependence on the client business. In order not to lose the client business, the incumbent auditor may soften the audit controls, or the client entity may express a desire to do so. While it may cause the audit to be far from impartiality and independence in order to protect mutual interests, in the case of mandatory audit rotation, it will not be binding to the auditors as the business relationship will end. It will be easier to maintain its independence and may reduce the auditor's potential to support the accounting policies of the client business. In addition, rotation practice can reduce the pressure that client management can put on auditors about fraudulent transactions and increase the auditor's potential to resist client management.

Since the incumbent auditor knows that a new audit firm that will replace him, close to the end of his term of office, will come to examine past audit activities and practices, in order to protect his professional reputation and not to compromise his independence and reliability, he performs all audit activities as meticulously as possible. The current audit firm may increase the audit quality by considering that the erroneous detections and actions in the audit activities will be noticed by the replacement team or a new audit firm and reported to the client business or other relevant parties. Since the rotation practice will be an inspection in this sense, it will increase the quality of the audit and encourage the auditors in a positive way.

In the audit sector, one of the biggest concerns of small-scale and less-known audit firms is that large-scale firms are preferred more by client companies, and thus there is a lack of potential competition. The practice of mandatory audit firm rotation may create competition among independent audit firms. Therefore, forced rotation may make small-sized audit firms competitive with large-scale firms.

In addition to the many benefits listed, some disadvantages of mandatory audit firm rotation are also stated. The first drawback that can be counted is the cost of time spent getting to know the client company (Pop ve Iosivan, 2008, s.12). In the scope of customer acceptance and planning in the audit activity; to know the customer's business, to know the customer's accounting system, to have information about the business activities, to have knowledge of the specific and general rules of the sector in which the customer is involved, to know the internal control system and to have knowledge. Firm rotation can place an additional burden on both the firm and the client business. In some cases, the customer may have to undertake almost all of this workload cost.

Mandatory audit rotation may result in the loss of client-specific information held by the audit firm. The new auditor's access to the client's accounting systems, internal control system, etc. It takes some time to become familiar with situations. During this time, the auditor may fail to notice potentially material errors, which may have an adverse effect on audit risk and quality (Myers, Myers ve Omer, 2003, s.3).

By displaying attitudes arising from the effort of the newly appointed auditor to prove herself, it may cause situations that may create excessive tension by displaying behaviors that criticize old practices.

As the mandatory rotation date approaches, independent audit firms may focus on efforts to acquire new customers instead of focusing on ongoing audit activities on existing client businesses, and may adversely affect the quality of the audit by disrupting their work. (Tuan, 2015, s.291-309).

Regulations and principles regarding rotation periods are included in article 400 of the Turkish Commercial Code (TCC) numbered 6102 and article 26 of the Independent Audit Regulation in Turkey (http://www.kgk.gov.tr/). According to paragraph 2 of Article 400 of the TCC, an auditor elected for a total of 7 years on behalf of the same business within 10 years cannot be re-elected as an auditor unless 3 years have passed. KGK is authorized to regulate the principles regarding the implementation of this paragraph and to shorten these periods.

Article 26 of the Independent Audit Regulation, 1/d. In the sub-paragraph, it is stated that audit firms will not be able to carry out audit services again, unless 3 years have passed, after 7 years of audit work in the same company in the last 10 years. It has been clearly stated that the independent auditors undertaking the audit and the auditors working in the same company for 5 years within the last 7 years will not be able to perform the audit service again unless 3 years have passed.

When we look at the USA, which has been discussing audit rotation for many years, and Europe, which adopted it in 2014 and started mandatory rotation practice in the middle of 2016, it is seen that audit team rotation is generally preferred. In Canada, mandatory audit firm rotation was introduced much earlier than in other countries. After the failure of the Home Bank of Canada in 1923 and the events that led to the suicide of some of the bank's customers, some regulations regarding auditing were made and remained in effect until 1991 (https://torontoist.com/2013/08/historicist-the-home-banks-house-of-cards/). In Spain, audit firm rotation was adopted in 1988 but was canceled shortly after. From 1988 to 1995, audit firm rotation was required every 9 years (Ruiz-Barbadillo, Gomez-Aguilar ve Carrera, 2009, s.113-135).

## 3. Literature

Studies investigating the impact of mandatory audit firm rotation on audit quality generally include audit rotation at the firm level or audit rotation at the audit team level.

There are studies on the effects of audit rotation at the audit firm level on audit quality. In one of these studies, the perceptions of credit managers on the subject, and in the other study, the perceptions of independent auditors on the subject were measured. In the first study, it was shown that mandatory audit rotation did not create a change in the perception of quality in the audit of the authority who will approve the loan (Daniels ve Booker, 2011, s.78-82). In the other study, it was concluded that the mandatory rotation of the auditors while performing their own work creates a positive perception of audit quality and auditor independence, while it causes negative effects on the auditor's experience and knowledge gained as a result of working with the client company for long periods of time (Anis, 2014, s.105). A 2008 study by Jackson, Moldrich, and Roebuck found that mandatory rotation at the firm level negatively affects audit quality (Jackson, Moldrich ve Roebuck, 2008, s.420-437). In the study conducted by Kwon, Lim, and Simnett in 2010, it was concluded that although mandatory audit firm rotation increased the costs of audit firms and client firms, it did not have any effect on audit quality (Kwon, Lim ve Simnett, 2010, s.1-61). In another study they found evidence that mandatory audit firm rotation improves audit quality (Cameran, Prencipe ve Trombetta, 2012).

Many studies have also been conducted on the effects of audit rotation at the audit team level on audit quality. In a study, it was argued that mandatory audit team rotation and the shortening of a team's audit period do not improve audit quality (Siregar, Amarullah, Wibowa ve Anggraita, 2012, s.55-74). In another similar study, it was claimed that rotation often increases the workload of auditors, has a negative impact on audit quality, albeit indirectly, and can cause unexpected problems (Daugherty vd., 2012, s.97-114). In another study, differences in audit quality between former and new partner lead auditors were examined. It has been determined that audit quality is lower for the former audit team than for the new partner lead auditor in audit firms subject to mandatory rotation (Chi, Huang, Liao ve Xie, 2009, s.359-391). In another study, it was observed that the data obtained for the newly appointed partner lead auditor, especially after rotation, provided positive evidence on audit quality and independence (Ewelt, Gold ve Pott, 2012). In the study carried out in 2013, the effect of personal and friendship relations between the responsible partner lead auditors, which are formed because they have worked in the same client business for many years, was examined. It has been determined that the quality of the audit increases when there is no personal relationship between the old and new partner lead auditors; however, it has been found that when a personal relationship exists between the former and new partner lead auditors, the quality of the audit drastically decreases and in some cases disappears altogether (Li, Xu ve Zhang, 2013, s.1-35).

In another study conducted in 2013, the effect of mandatory audit rotation at audit team level, which was implemented in China in 2004, on audit quality was examined. As a result of the study, it has been determined that the audit quality has increased with the mandatory audit rotation in regions where the audit work is not applied much, the legal regulations are insufficient, and the legal regulations introduced are fully implemented. However, it has been determined that audit quality has not increased as expected in regions with previously developed audit markets and large audit firms (Bandyopadhyay, Chen ve Yu, 2013, s.18-31). In the study conducted in China, which is the only study that examines the effect of all rotation practices on audit quality, no results were obtained showing that mandatory rotation at the audit firm level creates different effects from other rotation practices. In addition, it has been determined that the audit opinion expressed in the audit report is more likely to express an opinion in line with the interests of the client enterprise in audit firms located in underdeveloped regions, in audit firms subject to mandatory rotation at the audit team level. The same situation has been observed in audit firms that implement voluntary rotation (Firth, Rui ve Wu, 2012, s.109-138). In the study conducted in 2017, the relationship between audit firm tenure and audit quality in Turkey was examined and some evidence was found that there is no increase in audit quality when the audit firm tenure is limited. Considering the additional costs that may arise when changing audit firms, it is concluded that mandatory firm rotation provides minimal benefits (Türel, Genç, Özden ve Taş, 2017)

## 4. The Effect Of Audit Firm Rotation On Perceived Audit Quality

Although many studies have been conducted on audit rotation, there is no consensus on how mandatory rotation affects audit quality. Because audit firm rotation is still mandatory in a small number of countries, most of the work that has been done has focused on situations where audit rotations are performed on a voluntary basis.

The purpose of this research is to measure the effect of mandatory audit firm rotation, which is implemented in our country, on the audit quality perceived by financial statement users. A scale was used as a data collection method in the study. A total of 13 questions were developed, taking into account the literature review and previous research. The developed scale was directed to the people working in the loan allocation units, loan analysis units and project loan allocation departments of the banks. The questions within the scope of the scale were answered by 51 participants.

A questionnaire prepared with a 5-point Likert-type scale was conducted and the results were analyzed. Responses were rated from “1.Agree – 5.Strongly Disagree”. All of the participants participating in the research have 10 years or more of experience and all of them are people who make credit decisions by directly examining and analyzing the financial statements of their customers. This research is limited to public and private bank employees only in order to have more information about the questions to be asked. Opinions of investors, who constitute a significant part of financial statement users, are not included in the study. Within the scope of the research, only the compulsory rotation of the audit firm was taken into account, and the rotation of the audit team was excluded from the scope of the study.

With the questions asked to the participants, it was requested to evaluate how much the rotation of the audit firm, which is the dependent variable, affects the quality of the audit and how important it is. The questionnaire was sent to the participants electronically through the online survey program called “surveymonkey” and the data were collected electronically. The distribution of the answers given to the questions as a result of the analysis of the collected data is summarized in Table.1 below. The answers to question 13 were analyzed separately.

Table 1

*Distribution of Answers to Scale Questions*

| Question | Strongly Agree | Agree | Undecided | Disagree | Strongly Disagree |
|---|---|---|---|---|---|
| 1 | %29,41 | %5,88 | %15,69 | %39,22 | %9,80 |
| 2 | %19,61 | %17,65 | %15,69 | %43,14 | %3,91 |
| 3 | %13,73 | %54,90 | %23,53 | %5,88 | %1,96 |
| 4 | %13,73 | %27,45 | %25,49 | %33,33 | %0 |
| 5 | %30 | %36 | %24 | %8 | %2 |
| 6 | %3,92 | %19,61 | %27,45 | %47,06 | %1,96 |
| 7 | %9,80 | %15,69 | %25,49 | %47,06 | %1,96 |
| 8 | %7,84 | %7,84 | %19,61 | %60,79 | %3,92 |
| 9 | %0 | %23,53 | %21,57 | %50,98 | %3,92 |
| 10 | %13,73 | %58,82 | %23,53 | %3,92 | %0 |
| 11 | %14 | %38 | %34 | %10 | %4 |
| 12 | %11,76 | %37,26 | %31,37 | %17,65 | %1,96 |

1- “When audit firm rotation is obligatory, there is a decrease in the specific knowledge and experience of the client firm, which reduces the quality of the audit”; A total of 51 people responded and 39.22% of the participants stated that they did not agree with this recommendation, while 29.41% stated that they strongly agreed.

2-"The longer the audit firms work with the client, the higher the audit quality"; A total of 51 people responded and 43.14% of the participants stated that they did not agree with this recommendation, and 19.61% stated that they strongly agreed.

3-"Mandatory audit firm rotation actually increases auditor independence"; A total of 51 people responded and 54.90% of the participants stated that they agreed with this proposal and 23.53% stated that they were neutral.

4-"Mandatory audit firm rotation apparently increases auditor independence"; A total of 51 people responded and 33.33% of the participants stated that they did not agree with this recommendation, and 27.45% agreed that they agreed.

5- "Audit firm rotation should be mandatory" proposal; A total of 50 people responded, and 36% of the participants stated that they agreed with this recommendation, while 30% agreed that they strongly agreed.

6- "Mandatory audit firm rotation reduces the commitment to the client firm"; A total of 51 people responded and 47.06% of the participants stated that they did not agree with this recommendation, and 27.45% stated that they were neutral.

7- "Mandatory audit firm rotation reduces specialization related to client business" proposal; A total of 51 people responded and 47.06% of the participants stated that they did not agree and 24.49% stated that they were neutral.

8- "The quality of the current audit will decrease, as changes will be made in the periods when there will be mandatory audit firm rotation"; A total of 51 people responded and 60.79% of the participants stated that they did not agree with this recommendation, and 19.61% stated that they were neutral.

9- "The first year of compulsory audit firm rotation, the quality of the audit decreases, since the new team is inexperienced in that client's business"; A total of 51 people responded and 50.98% of the participants stated that they did not agree with this recommendation, while 23.53% agreed.

10-"Mandatory audit firm rotation prevents incorrect and aggressive accounting practices in the client business"; A total of 51 people responded and 58.82% of the participants stated that they agreed with this proposal, while 23.53% stated that they were neutral.

11- To the suggestion "Establishing a time limit for how long an audit firm can continue to audit the client firm increases the perception of auditor independence"; A total of 50 people responded, and 38% of the participants agreed with this recommendation, while 34% said they were neutral.

12- "Mandatory audit firm rotation reduces the pressure of the management on the auditors"; A total of 51 people responded and 37.26% of the participants stated that they agreed with this proposal, and 31.37% stated that they were neutral.

13- "How many years should the rotation of the audit firm of publicly traded companies be mandatory"; A total of 49 people responded. 20 people said that the audit firm rotation should be every 10 years, 4 people every 4 years, 5 people every 2 years. On the other hand, 20 people replied that there should be no audit firm rotation (0 years).

## 5. Conclusion

In this study, the effect of mandatory audit firm rotation on perceived audit quality has been examined. According to the results obtained; Evidence has been obtained that audit firm rotation should be mandatory and that rotation increases auditor independence not only in appearance but in reality. It has been determined that knowing that there is a time limit in the audit increases the perception of auditor independence. It is thought that the possible pressures that the client business management may create on the auditors can be prevented by mandatory audit firm rotation, and this rotation can prevent incorrect and aggressive accounting practices in the client company.

In addition, according to the answers of the participants; It has been concluded that when the rotation of the audit firm is mandatory, there will not be a decrease in the special knowledge and experience of the client company, this will not adversely affect the quality of the audit, the quality of the audit is independent of the long periods of working with the client company, besides, the mandatory audit rotation will not adversely affect the audit quality and will not reduce specialization.

When the results are evaluated collectively; Evidence has been obtained that mandatory audit rotation has an impact on the perception of independence, can contribute positively to audit quality, and prevent pressure on auditors. However, strong conclusions could not be reached regarding the positive effect of audit firm rotation on the perception of audit quality.

When the collected data is analyzed; Regarding the necessity of audit firm rotation, more than 60% of the participants answered that it should be mandatory, while more than 50% stated that mandatory audit rotation would not reduce the quality of the audit. Likewise, nearly 50% of the participants emphasized that working with the client company for many years would not positively affect the audit quality. One of the interesting findings in the survey study is that mandatory audit firm rotation does not have a significant effect in reducing the pressure of client business management on auditors.

It is expected that the results of the study will contribute to the organizations that make regulations on independent auditing in our country and in other countries. It is expected that the findings obtained as a result of this research will contribute to the future regulations of the KGK on the subject. In future studies, it can be investigated how the mandatory audit firm rotation and the mandatory audit team rotation are perceived not only by the employees who make the credit decision, but also by the investors.

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