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The impact of ex-auditors' employment with audit clients on perceptions of auditor independence

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Abstract

It is a common knowledge that auditors often being offered a position in their clients' firms. However, following the collapse of Enron and other infamous financial scandals like Global Crossing and Waste Management in the US, the accounting profession was brought into sharp focus particularly regarding issues that may affect auditor independence. One of the issues is the practice of auditors seeking employment with their audit clients. Therefore, the main objective of this study is to examine whether the practice of ex-auditors' employment with audit clients affects perceptions of auditor independence from the perspective of financial statement users in Malaysia.

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Keywords: auditor-client employment; auditor independence; financial scandals; audit partner; skepticism.

1. Introduction

Prior research has shown that it is not uncommon for auditors to be offered a position in clients' firms (Imhoff, 1978; Koh and Mahathevan, 1993; Iyer and Raghunandan, 2002). This has been called a 'revolving door', the practice whereby audit clients hire senior financial reporting executives directly from their external audit firms (Clikeman, 1998). Clients often prefer to hire former employees of their audit firms because the former auditors have the advantage of knowledge of the clients' business, financial reporting processes and other information systems that other candidates

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outside the audit firms do not have (Beasley, Carcello and Hermanson, 2000). However, following the collapse of Enron in 2001 along with other infamous financial scandals like Global Crossing and Waste Management, the accounting profession has been brought into sharp focus regarding the issue of ex-auditors seeking employment with their audit clients. This is because, in each of these companies the senior accounting and finance officers were hired directly from their external auditors (Menon and Williams, 2004; Geiger, North and O'Connell, 2005).

The problem with auditor independence may begin when auditors use their auditing experience as a means of obtaining managerial positions with audit clients. In making this transition or simply looking into the opportunity of re-employment, "a shadow is cast on the auditor's ability to attest independently to a prospective employer's financial statements" (Imhoff, 1978, p. 870). Lennox (2005) expressed concern that collusion with an audit client might occur before auditors leave the audit firm since at that time, they may be negotiating a lucrative employment contract with the client, thus making the auditors unwilling to confront the management with problems discovered during that audit.

The main problem with employment with an audit client is the ability of current auditors to remain independent when dealing with top managers who were previously fellow auditors (Imhoff, 1978; Koh and Mahathevan 1993; ISB 2000, Fearnley and Beattie, 2002). Menon and Williams (2004) argued that the current auditors are seen as being likely to trust their former partners because of prior affiliation with the audit firms and that this trust may lead to the auditors' willingness to adjust audit procedures. In their worst case scenario, Fearnley and Beattie (2002) described that an inexperience current audit partner, or one nervous with losing an audit client, may also not be able stand up to a bullying or intimidating director, who is himself a former audit manager or an audit partner of the firm.

In response to increasing public skepticism about the practice of companies hiring their auditors and the negative publicity from audit failures such as Enron and WorldCom, regulators particularly in the US have specifically addressed this issue by inserting a provision (Section 206 of the Sarbanes Oxley Act (SOX) 2002) that forbids public companies from hiring accounting and finance officers from their external auditors for up to one year from the personnel's departure from the audit firms (Securities Commission (SEC), 2003). The International Federation of Accountants (IFAC) also emphasized concern, stating that taking up an employment with an assurance client may create self-interest and familiarity threats to the audit personnel who may join the assurance client sometime in the future (IFAC, 2014).

The Malaysian Institute of Accountants (MIA) has also addressed the issue of auditor employment through its By-Laws (MIA, 2010, p. 70) which stated:

'Independence would be deemed to be compromised unless, subsequent to the partner ceasing to be a key audit partner, the public interest entity had issued audited financial statements covering a period of not less than two years and the partner was not a member of the audit team with respect to the audit of those financial statements.'

The ISB (2000), however, rejected the mandated 'cooling-off' period as the board believed that the costs of such a rule would exceed its benefits. Though the board recognized that the rule may promote the appearance of independence, they were concern that the caliber of professional attracted to public accounting might decline as a result of future employment prospects of those joining audit firms were limited by the mandated cooling-off period. The board also argued that the cooling-off period would be ineffective in preventing fraud or collusion between the auditors and their clients. This is because banning the auditors from working for their clients for a period of time would not avert the clients from making payments to the auditors and it would also not prevent the auditors from contacting or dealing with the clients after their resignation from the audit firms.

Research in the area of auditor independence is extensive particularly when accounting firms have widened the scope of their services beyond their traditional audit services. Subsequent to the issuance of the SOX 2002 in the US, research has placed most attention on the on-going debate regarding the provision of non-audit services to audit clients and the potential these services pose to compromising auditors' objectivity and independence. On the other hand, research on the practice of ex-auditors seeking employment with audit clients seemed to be lacking albeit it is not merely a theoretical issue (Dart and Chandler, 2012). Since there is very little recent perceptual research in this area, the current study contributes to the body of knowledge and understanding regarding whether ex-auditors' employment with audit clients affects perceptions of auditor independence from the perspectives of financial statement users namely; corporate loan officers and professional investors. The study also examines whether the financial statement users consider the current regulations regarding the issue to be effective in safeguarding auditor independence. The study is also motivated by DeFond and Francis (2005), who believed that the issue of ex-auditors seeking employment with audit clients will continue to be an important issue and urged that further research be conducted because of the effect this partiality may have on accounting firms.

2. Selected Literature Review

The review of the literature on ex-auditors' employment with audit clients showed findings that are consistent with the suspicion that the 'revolving door' practice has a negative impact on auditor independence. Imhoff (1978) provided early evidence that auditor independence was perceived as more likely to be impaired when auditors were in a supervisory position than if they were in non-supervisory positions before accepting employment at a client's firm. Imhoff's findings were supported by a subsequent study, Koh and Mahathevan (1993), which examined the auditor-client employment issue from the perspective of middle-level managers in Singapore. They improved upon the study of Imhoff (1978) by examining additional factors affecting concerns about auditor independence. For the additional factors tested, the results revealed that the current position of an ex-auditor with a client significantly influenced how the subsequent audit was performed, with independence being questioned more when an auditor accepted a position as a preparer as opposed to non-preparer of financial statements.

Prior research has also investigated auditor-client employment issue from the perspective of auditors' reporting intention. Kaplan and Whitecotton (2001) examined auditors' reporting intentions when faced with the knowledge that an audit manager is considering employment with an audit client. The results of their study indicated that auditors with higher perceptions of responsibility showed stronger intentions to report the employment than did auditors with lower perceptions of responsibility. Conversely, auditors who perceived that the cost of reporting was relatively high showed lower reporting intentions than those perceiving a lower cost of reporting. This study, whilst not directly related to the current study, provides some insight on the challenge of implementing the client employment ethics ruling.

In another study, Iyer and Raghunandan (2002) examined CPA firm alumni's perceptions about their ability to resolve disagreements with auditors who happen to be their former employers. Their results indicated that the alumni's prior position as partners or other supervisory positions and the time elapsed since leaving the firm did not significantly alter their perceptions. The study also revealed that the alumni from the audit area were more likely to indicate that they could resolve disagreement more easily if the former CPA firm served as the auditor than the alumni from other areas. These findings provided some evidence to support the regulators' concern about the risk of independence impairment when alumni seek employment with their former clients. The study suggested that auditors may need to be sensitized in order to maintain a professional skepticism when dealing with former colleagues in resolving disputes.

In a survey of members of state boards of accountancy in the US, Wright and Booker (2005) found that the employment of senior auditors in a client company was perceived as damaging auditor independence. Consistent with prior findings, it was found that auditors' prior supervisory position was viewed as impairing independence more than would a non-supervisory position. The study also found that longer cooling-off periods reduced the potential for independence impairment.

While most prior findings seemed consistent with regards to perceived impact on auditor independence when companies hire their ex-auditors, the results of a study by Sori and Mohamad (2007) were not. This study investigated senior managers' of banks and listed companies perceptions through interviews. The majority of interviewees were of the opinion that the impact of auditor employment was minimal. This was due to the small size of Malaysian capital market that may have caused the auditors to behave consistent with the professional standards. The study also found evidence consistent with ISB (2000) with regard to restriction imposed on auditors seeking employment with audit clients being costly.

Based on a questionnaire survey conducted in 2005, Dart and Chandler (2012) examined whether the presence of ex-auditors working in a senior management role would have an influence on investors' perceptions of auditor independence in the UK. In contrast to previous findings, the results of the study indicated that the UK investors did not view the client's employment of a previous auditor as a threat to auditor independence. Further tests showed that institutional investors were less critical in their perceptions of the threats of auditor employment than were private investors. The study also examined investors' perceptions of what constituted a reasonable cooling-off period between an auditor leaving an audit firm and joining an audit client. They found that the majority of the respondents preferred a cooling-off period of no more than one year and concluded that further legislation on this issue may not be supported.

3. Research Methodology

The main objective of this study is to examine whether the practice of ex-auditors' employment with audit clients affects perceptions of auditor independence from the perspective of financial statement users in Malaysia. To achieve the research objective, this study employed a quantitative methodology through a self-administered postal questionnaire survey. Respondents were asked to state their agreement to statements related to auditor employment with audit client issue on a five-point Likert scale ranging from strongly disagree (1) to strongly agree (5). The questionnaire surveys were pilot tested before they were sent to actual respondents.

The population selected for this study consists of financial statement users mainly corporate loan officers and professional investors in Malaysia. The literature review revealed that loan officers and investors are among those most likely to use audited financial statements in making business decisions and thus most likely to appreciate auditor independence (Firth, 1980). Corporate loan officers were also selected because they are relatively sophisticated financial statement users who could understand the importance of auditor independence (Gul, 1991) and they are considered most likely to deal with listed companies' loan applications. Thus, it was possible to locate the target respondents mainly in the headquarters of their companies. Professional investors in this study were represented by analysts and fund managers, both of whom have been identified as the most important professional investor groups in the capital market (Moizer and Arnold, 1984). The sampling approaches employed by Abu Bakar, Rahman and Rashid (2005) in selecting corporate loan officers and Ku Ismail and Chandler (2005) for professional investors were replicated in this study. Table 1 summarizes the responses on the questionnaires from the corporate loan officers and professional investors respectively.

Table 1. Analysis of Responses by Respondents Category

Category	Total Questionnaires Issued	Initial Mailing - Usable Responses (%)	1st Follow Up - Usable Responses (%)	2nd Follow Up - Usable Responses (%)	Total Usable Responses (%)
Corporate Loan Officers:	210	20 (10%)	42 (20%)	48 (23%)	110 (52%)
- Commercial banks	140	13	25	33	71 (51%)
- Islamic banks	70	7	17	15	39 (56%)
Professional Investors:	262	14 (5%)	39 (15%)	14 (5%)	67 (25%)
- Investment banks	70	7	13	5	25 (36%)
- Non-investment banks	57	3	15	-	18 (32%)
- Fund management company	123	4	7	3	14 (11%)
- Public funds organisations	12	-	4	6	10 (83%)
TOTAL	472	34 (7%)	81 (17%)	62 (13%)	177 (38%)

4. Results and Discussion

There were 177 usable responses received after three mailings from corporate loan officers and professional investors. An analysis was carried out on background information of the respondents and the findings are tabulated in Table 2. The majority of the respondents in both groups were males, aged at least 31 years old and hold at least a bachelor degree. The majority of corporate loan officers were in managerial positions (53%), hence they were most likely to be involved in the loan approval process for the banking group. As for the professional investors, the majority of the respondents were analysts (58%) while 39% were fund managers. In terms of working experience, the majority of the respondents have at least five years of experience in their present positions. The seniority of the respondents may provide a strong support for the belief that their responses would give a more reliable source of information on the issue under study.

Table 2. Respondents' Background Information

	Corporate Loan Officers		Professional Investors			Corporate Loan Officers		Professional Investors	
	Frequency	%	Frequency	%		Frequency	%	Frequency	%
Gender:					Work Experience:				
Male	58	52.7	41	61.2	Less than 5 years	42	38.2	21	31.3
Female	52	47.3	26	38.8	5-10 years	32	29.1	23	34.3
	110	100	67	100.0	11-15 years	20	18.2	18	26.9
Age:					16-20 years	12	10.9	4	6
30 years or less	39	35.5	28	41.8	More than 20 years	4	3.6	1	1.5
31 – 40 years	44	40.0	19	28.4		110	100	67	100
41 – 50 years	24	21.8	15	22.4	Designation:				
51 – 60 years	3	2.7	5	7.5	Manager	58	52.7	-	-
	110	100	67	100	Senior Officer	22	20	-	-
Education Level:					Officer	29	26.4	-	-
Diploma	4	3.6	1	1.5	Analyst	-	-	39	58.1
Bachelor Degree	83	75.5	42	62.7	Fund Manager	-	-	26	38.9
Masters' Degree	16	14.5	16	23.9	Others	1	0.9	2	3
Professional	5	4.5	7	10.4		110	100	67	100
Others	2	1.8	1	1.5					
	110	100	67	100					

The results in Table 3 indicate that, based on the percentage of responses, the respondents were most concerned about the independence of the auditors who seeks employment with an audit client as compared to the last audit conducted and subsequent to joining the audit client. The results of the one-sample Wilcoxon signed rank test (WSRT) confirm the descriptive findings since significant differences were found between both samples' medians and 3 for the three statements.

Table 3 also show that the majority of respondents in both groups agreed with the statement that auditors' prior supervisory position such as audit partners would threaten the independence of the remaining audit engagement team when the auditor joins a client company. On the other hand, if the auditor was not an audit partner, the percentage of respondents who believed that auditor independence would be threatened decreased considerably. The results of the one-sample WSRT, however, indicate that both groups of respondents tend to agree that an ex-audit senior (who is not an audit partner) working for an audit client would also threaten the independence of the remaining audit engagement team.

Table 3 further reveal the respondents' agreement that when the auditor's current responsibility at the client company involved preparation of company accounts, the ability of the remaining auditors to stay independent would be affected. When the senior auditor's current responsibility does not involve preparation of the company's accounts, the percentage of respondents who agreed with the statement decreased substantially. For the first statement, the results of the one-sample WSRT are significant; they show the tendency of the respondents to agree with the statement. As for the second statement, the result of the one-sample WSRT for the professional investors is significant but it may indicate their tendency to disagree with the statement (median = 3, mean = 2.73) while the loan officers seemed unaffected.

Table 3. Respondents' Perceptions of Auditors' Employment with an Audit Client

	Corporate Loan Officers (n = 110)			Professional Investors (n = 67)			One-Sample WSRT (test value = 3)	
	Disagree	Neutral	Agree	Disagree	Neutral	Agree	Loan Officers (Sig)	Prof. Investors (Sig)
I am concerned about the independence of:								
• a senior auditor who seeks employment with his/her current audit client.	9.1%	24.5%	66.4%	7.4%	29.9%	62.7%	0.000*	0.000*
• the last audit of the client's financial statements that the senior auditor has conducted prior to joining the client company.	7.3%	26.3%	66.4%	9.0%	34.3%	56.7%	0.000*	0.000*
• the remaining audit engagement team in their future audits after their senior auditor joins the client company.	10.0%	38.2%	51.8%	7.5%	37.3%	55.2%	0.000*	0.000*
When a senior auditor joins a client company, the independence position of the remaining audit engagement team in their future audits would be threatened if:								
• The senior auditor had been an audit partner.	10.0%	30.9%	59.1%	9.0%	26.9%	64.1%	0.000*	0.000*
• The senior auditor was a member of the engagement team, but not an audit partner.	10.0%	55.5%	34.5%	11.9%	44.8%	43.3%	0.000*	0.000*
• The senior auditor's current responsibility at the client company involved preparation of company's accounts.	6.4%	29.1%	64.5%	9.0%	31.3%	59.7%	0.000*	0.000*
• The senior auditor's current responsibility at the client company does not involve preparation of the company's accounts.	23.6%	53.6%	22.8%	37.3%	49.3%	13.4%	0.704	0.015*[#]

*Significant at the 5% level.
[#] The mean responses was 2.73 and the median was 3.

Further analysis of the results was conducted using the Wilcoxon matched-pairs signed rank test to determine whether there is a statistically significant difference in the respondents' perceptions between the two auditors' prior positions as audit partners and non-audit partners and between the auditors' subsequent position at the client company involving and not involving preparation of the company's accounts. The test was conducted on both the corporate loan officer and professional investor samples. The results of the test, in Table 4, show statistically significant differences in the respondents' perceptions between the auditors' prior positions as audit partners and non-audit partners and between their current positions at the client company that involved and does not involve preparation of the company's accounts.

Table 4. Analysis of Differences in Respondents' Perceptions between Auditors' Prior Positions and Current Positions at the Client Company

Wilcoxon Matched-Pairs Signed Rank Test		
Pairs	Corporate Loan Officers (n = 110)	Professional Investors (n = 67)
(a)&(b)	z = -4.251, p = 0.000*	z = -4.235, p = 0.000*
(c)&(d)	z = -6.314, p = 0.000*	z = -5.485, p = 0.000*

* Significant at the 5% level.

When a senior auditor joins a client company, the independence position of the remaining audit engagement team in their future audits would be threatened if:

a) the senior auditor had been an audit partner,
b) the senior auditor had been a member of the audit engagement team, but not an audit partner,
c) the senior auditor's current responsibility at the client company involved preparation of company's accounts,
d) the senior auditor's current responsibility at the client company does not involve preparation of the company's accounts.

Table 5 reports respondents' perceptions of the sufficiency of a cooling off period of two years that audit firms must observe before an audit partner joins an audit client to safeguard auditor independence. The results reveal that the majority of corporate loan officers were satisfied with the 2-year cooling-off period as a safeguard to auditor independence. These results indicate support for the MIA's regulation forbidding audit firms from performing an audit for a listed client unless a 2-year period has passed since the ex-auditor acted as the audit engagement partner for that listed client. The result of the one-sample WSRT for the corporate loan officers is significant which means that there is a tendency for the loan officers to agree with the current regulation.

Table 5. Respondents' Perceptions of Sufficiency of a Cooling-off Period of 2 Years

	Corporate Loan Officers (n=110)			Professional Investors (n=67)			One-Sample WSRT (test value = 3)	
	Disagree	Neutral	Agree	Disagree	Neutral	Agree	Loan Officers (Sig)	Prof. Investors (Sig)
A 2-year cooling-off period before an audit partner could join a client company is sufficient to safeguard auditor independence.	17.3%	23.6%	59.1%	25.4%	32.8%	41.8%	0.000*	0.123

* Significant at the 5% level.

5. Conclusion

The current findings should be considered in the light of the inherent limitations common to any prior survey research namely; respondent representativeness, respondents' different interpretations of the questions, low response rates and non-response bias, that are inevitable to some degree. This study contributes to the existing literature on auditor independence by providing some evidence regarding the practice of ex-auditors seeking employment with their audit clients from the perspectives of an emerging market, particularly the Malaysian context. The current findings are consistent with the majority of prior perceptual studies examined, which concluded that the appearance of auditor independence is negatively affected by the auditor-client employment issue (Imhoff, 1978; Koh and

Mahathevan, 1993; Iyer and Raghunandan, 2002; Wright and Booker, 2005). The results however, contradict the findings in the other Malaysian study, Sori and Mohamad (2007), as they found lack of evidence to support the current findings. The current results also reveal that a supervisory position held by an ex-auditor prior to joining an audit client was viewed as impairing independence more than was a non-supervisory position held previously. Despite these findings, it was also highlighted that the respondents tended to agree that an ex-audit senior (non-audit partner) working for an audit client would still threaten the independence. This may indicate that some respondents were still worried that ex-audit seniors' prior positions as non-audit partners (i.e. audit managers or audit seniors) could still influence the independence of the remaining auditors. The current findings also indicate that the current position of an ex-auditor significantly influenced how subsequent audits would be performed with independence being questioned more when the ex-auditor accepts a position as a preparer of, rather than as a non-preparer of financial statements.

The results of this study also suggest that the 2-year cooling-off period could reduce the negative impact on independence from the revolving door practices of former senior auditors accepting significant positions with audit clients. This finding is consistent with the MIA By-Laws' requirement. Nevertheless, the SOX 2002 and IFAC (2014) only require a 1-year cooling-off period before publicly held companies may employ their audit firms' former employees or partners for key positions. The current results did not support a recommendation for a shorter cooling-off period of 1-year as the respondents seemed to still have faith in the current regulation.

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