Perceptions of independence and auditor rotation: An examination of nonprofit organizations

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ABSTRACT

This study provides the survey results of chief officers of Single Audit Act nonprofit organizations. This paper investigates the perceptions of auditor independence and auditor rotation for nonprofit organizations (NPOs). Specifically, we address two research questions. First, what are chief officers' general views regarding independence for nonprofit organizations? Second, what are chief officers' general views regarding audit partner and audit firm rotation?

The researchers developed a thirteen question survey which relates to auditor independence and/or auditor rotation for nonprofit organizations. Chief executive officers (CEOs) and chief financial officers (CFOs) of Single Audit Act nonprofit organizations are surveyed. A majority of the Chief Officers believe that independence is the foundation of an audit for nonprofit organizations. In addition, nonprofit organizations should have auditors who are independent in fact and appearance. When examining partner or firm rotation as ways to enhance auditor independence for nonprofit organizations, the Chief Officers did not come to a consensus. However, they do believe that the cost would outweigh the benefits.

The results of this study are limited to the views of chief officers of NPOs that are required to have an independent audit conducted in accordance with the Single Audit Act. Future research can examine the views of chief officers not subject to the Single Audit Act. Furthermore, it would be interesting to examine the views of other stakeholders (lenders, donors, etc.) of Nonprofit Organizations. The results add to the auditor rotation literature by examining nonprofit organizations. The study provides insight into auditor independence standards for nonprofit organizations. The independent audit is important for nonprofit organizations and examining ways to enhance auditor independence is very relevant.

Keywords: rotation, independence, nonprofit, CEO, CFO, audit

INTRODUCTION

Nonprofit organizations (NPOs) are similar to for-profit organizations in the United States and play a vital role in providing services and benefits that have a significant impact on the economy. In 2012, NPOs provided 11.4 million jobs which is about 10.3% of U.S.'s private sector workforce), according to the Bureau of Labor Statistics (2014). In 2010, NPOs spent approximately $587 billion in wages and benefits to employees (Roeger et al. 2012). However, both types of organizations are similar in some respects, especially in their responsibility to prepare accurate and reliable financial reports for investors and creditors. Unfortunately, this is not always the case. For example, in the early part of the 21st Century, high-profile scandals such as Enron and WorldCom occurred in the for-profit sector, similar scandals like United Way and American Red Cross occurred in the NPO sector. In the aftermath of the for-profit scandals, Congress enacted the Sarbanes-Oxley Act of 2002 (SOX) to increase auditor independence and accountability for publicly-traded companies. Some provisions of SOX have been adopted by NPOs; however, very few relate directly to strengthening auditor independence via auditor/partner rotation. The purpose of this study is to gain a better insight into auditor independence by examining chief officers' perceptions of auditor independence and mandatory auditor rotation in the NPO sector of the audit market.

AUDITOR INDEPENDENCE

Actual and perceived independence should be the foundation of the independent audit for public and nonpublic companies (nonprofit organizations, private companies, government agencies, etc.). The American Institute of Certified Public Accountants (AICPA) believes that independence standards should differ based on public and nonpublic companies (AICPA, 2003). Carmichael (2004) disagrees and believes that independence standards should be the same for public and nonpublic companies because an audit should provide the same level of confidence and social usefulness.

In 2002, SOX was introduced to enhance auditor independence by restricting non-audit services and partner rotation. Although SOX applies to public for-profit organizations, it is plausible that SOX will eventually extend to NPOs. According to Hempel and Borrus (2004), several states are considering similar regulations for nonprofit organizations. While SOX only focuses on public companies, Bradford and Brazel (2007) note that some nonprofit entities have adopted some of the provisions of SOX. In 2004, Governor Arnold Schwarzenegger signed the Nonprofit Integrity Act for NPOs in California. The Integrity Act requires: Organizations with gross revenues of 2 million dollars or more to prepare audited financial reports in accordance with GAAP, have an independent audit committee appointed by the Board, and have the Board approve CEO/CFO compensation. Nezhina and Brudney (2010) find that CEO familiarity with SOX, CEO attitude toward SOX and organization size help explain nonprofits' adoption of SOX provisions.

AUDITOR ROTATION

Auditor rotation is a continuous topic of interest and prior research has mixed results about whether partner or firm rotation enhances perceived auditor independence. This subject is not only a topic of interest in the United States of America (U.S.). Several countries are debating or have implemented some type of rotation policy. According to Catanach and Walker (1999), non-U.S. countries such as Canada, Australia, Germany, and the United Kingdom have considered implementing some type of auditor rotation policy. Among the countries that have implemented a rotation policy are Israel, Italy, and Spain. The U.S. implemented the partner rotation policy due to SOX, but not a firm rotation policy; although this discussion has resurfaced by the Public Company Accounting Oversight Board (PCAOB). Despite the implementation of the partner rotation policy, independence continues to be a problem in auditing. On April 1, 2015, the PCAOB sanctioned five individuals and two of the charges related directly to auditor partner rotation and cooling-off violations along with bookkeeping and audit services to the same client (PCAOB, 2015).

The following sections of this article describe the authors' research questions, questionnaire, findings, and recommendations and avenues for future research.

RESEARCH QUESTIONS

As an exploratory analysis, the authors focus on understanding the perceptions of financial statement preparers regarding independence and mandatory audit firm rotation in a nonprofit environment. The profession maintains that auditors must be independent "in fact," and independent "in appearance." In light of recent events, there is a heightened awareness of the issue of independence and a perception problem in that maintaining independence in appearance has become difficult for some firms. According to the SEC (2000):

> It is therefore not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional.

To gather evidence on the perceptions of financial statement preparers of nonprofit organizations, the authors pose two research questions to investigate chief officers' views concerning independence (RQ1) and audit partner and firm rotation (RQ2). The exploratory questions are as follows:

RQ1: What are chief officers' general views regarding independence for nonprofit organizations?

RQ2: What are chief officers' general views regarding audit partner rotation and audit firm rotation?

Empirical evidence is mixed on the benefits of implementing partner and/or firm rotation. Kaplan and Mauldin (2008) find that there is not a significant difference between partner and firm rotation on perceptions of auditor independence. However, other studies find that firm rotation does increase perceptions of auditor independence (Dopuch et al. 2001; Arel et al. 2006; Jennings et al. 2006; Daniels & Booker 2011). Gates et al. (2007) find that firm rotation (not partner rotation) affects confidence in financial statements, Furthermore, Schmidt and Cross (2014) find that partner rotation impacts negotiation strategies that management uses to resolve reporting issues.

Jackson et al. (2008) find that firm tenure (firm rotation) decreases audit quality. However, Fargher et al. (2008) find that partner tenure (partner rotation) increases audit quality but decreases management's accounting discretion; firm rotation increases management's accounting discretion. Moreover, Comunale and Sexton (2005) find that mandatory auditor rotation has substantial impacts on long-term market shares.

The questionnaire consists of thirteen (13) statements soliciting chief officers' views in two areas: independence and mandatory auditor rotation. Three statements relate to independence and ten statements relate to partner and firm rotations. Each question is answered on a 5-point Likert scale as follows: 1 = Strongly Disagree, 2 = Disagree, 3 = Neutral, 4 = Agree and 5 = Strongly Agree. Responses of 1 and 2 are collectively referred to as "disagree", and responses of 4 and 5 are collectively referred to as "agree".

Table 1 (Appendix) provides the demographic information for 100 of the 102 respondents (2 respondents did not provide demographic information). A vast majority (97%) of respondents have a bachelor degree or higher. Eighty percent (80%) of respondents are CFOs and CEOs (with the other 20 percent consisting of controllers, vice-president of finance, etc.). A majority (84%) of respondents have 5 years or more nonprofit experience. Furthermore, 83 percent of respondents are the age of 46 years or older and 58 percent are male.

FINDINGS

This section provides the results of chief officers' perceptions of auditor independence and audit rotation. Thirteen statements are used to obtain these perceptions. In addition, four supplemental questions and additional comments are provided from chief officers of nonprofit organizations.

Independence

Table 2 (Appendix) provides the summary of percentages, means, and standard deviations for the thirteen statements. Statements 1, 2, & 3 capture information on independence related issues. Results suggest that participants support the fact that independence is the cornerstone of the auditing profession. A large majority (90%) of respondents agree that independence is the foundation of the independent audit, and less than 2% disagree (Statement 1). Over 91% of the respondents agree that auditors should be independent in "fact and appearance" for nonprofit organizations (Statement 2), and 76% of respondents agree that the perception of independence is as important as the auditor being independent in fact (Statement 3).

The AICPA's standard states that independence is important in fact and appearance because it is vital that the public is confident in the independence of the auditor (AICPA, 2014, ¶3). To that end, it is imperative that auditors are perceived to be independent. Several studies find perceived auditor independence to be important by examining perceptions of auditor independence from AICPA members, bank loan officers, and financial analysts on various aspects of auditor independence (Lavin 1976; Lavin 1977; Lavin & Libby 1977). The results indicate that there is an overall consensus among the chief officers on perceived independence: Statements 1 & 2 show that 90% agree and Statement 3 show that 76% agree.

Mandatory Audit Rotation

In Table 2 (Appendix), Statements 4 through 13 examine chief officers' views regarding partner and firm rotation. One of the provisions of SOX requires that audit partners rotate every five years. Furthermore, Section 203 of SOX specifies that the lead (or coordinating) audit partner which has the primary responsibility for the audit or the engagement review audit partner, which is responsible for reviewing the audit should not perform audit services for a public entity more than five years (U.S. Congress, 2002). According to the GAO, partner rotation is a way to enhance auditor independence and audit quality and to restore public confidence (GAO, 2003, pp.11).

Approximately, 42% of the respondents disagree that implementing an audit partner rotation policy will increase auditor independence for nonprofit organizations (Statement 4), while 27% agree and 30% remain neutral. On the other hand, when the statement indicates that implementing an audit firm rotation policy will increase auditor independence (Statement 5), the percent of respondents who disagree increased slightly to 46%, while 27% agree and 26% remain neutral. A large percentage of respondents disagreed that implementing audit partner or audit firm rotation would increase auditor independence. Responses to these statements suggest that chief officers are sensitive to rotation issues.

Statements 6 and 7 state that audit partner and audit firm rotation should be mandated for nonprofit organizations. Approximately 46% of respondents disagree that audit partner rotation should be mandated (Statement 6), while 34% agree and 20% remain neutral. These percentages vary significantly when the statement suggests that audit firm rotation should be required for nonprofit organizations (Statement 7).

Approximately 69% of respondents disagree that audit firm rotation should be mandated, while 23% agree and 9% remain neutral. The results suggest that chief officers are more in favor of mandatory partner rotation versus mandatory audit firm rotation. The responses to the open-end questions indicate that the cost will exceed benefit as a plausible reason against firm rotation.

Chief officers are asked to indicate their level of agreement or disagreement with two statements (Statements 8 and 9), each of which asserts a five year rotation policy for partner and audit firm. Responses reveal that there exists a consensus among the chief officers since a large majority disagrees with mandatory partner and firm rotation every five years. Statement 8 asserts that nonprofit organizations should be required to change audit partner every five years. The results show that over half of the respondents (58%) disagree, while 23% agree to the change. Statement 9 asserts that nonprofit organizations should be required to change audit firms every five years. Again, more than two-third (68%) disagrees with this statement, and only 13% agree. Moreover, one-fifth of the participants neither agreed nor disagreed with changing audit firms or audit partners every five years. The results of these statements suggest that most of the chief officers are not in favor of nonprofit organizations rotating audit partners or firms every five years. Comments to open-end questions indicate that some respondents think five years may not be long enough, which is consistent with findings the GAO reported in its 2003 questionnaire of public companies' audit committees, over half of the respondents (66%) reported that the rotation period should be eight years or more.

Statements 10 and 11 examine participants' views regarding voluntarily implementing a rotation policy. The responses to Statement 10 reveal that participants are almost equally split between agreeing (32%) and disagreeing (35%) that nonprofit organizations should not voluntarily implement a policy of audit partner rotation with 32% neutral. When the statement indicates that nonprofit organizations should not voluntarily implement a policy of audit firm rotation (Statement 11), the percentage of respondents agreeing increased from 32% to 43%; while 29% disagree and 27% are neutral. The results suggest that more of the respondents oppose firm rotation than partner rotation. However, there is not a consensus about whether partner rotation or firm should be voluntarily implemented.

In October 2009, The Financial Accounting Standard Board (FASB) created a Not-for-Profit Advisory Committee as a means to hear from the various stakeholders and help improve U.S. GAAP. Among other things, the Advisory Committee is to advise the board on whether the cost of implementing a new standard would be justified by the benefits. When the respondents are asked to state their agreement or disagreement related to whether the cost of rotation would likely exceed the benefits of rotation, more than one-half (52%) of the respondents agree that the cost of partner rotation would likely exceed the benefits for NPOs (Statement 12). This percentage increased to 62% when asked about cost versus benefits for audit firm rotation (Statement 13). Overall, the majority of respondents believe the cost of audit partner and audit firm rotations would exceed the benefits.

Supplemental Questions

To gain further insight into the participants' perceptions of audit partner or firm rotation conditions, two additional questions are asked. Each of the questions requires a "yes", "no" or "not sure" response. Table 3 (Appendix) provides the summary of percentages for the supplemental questions relating to auditor rotation. Question 1 asks, "Do you support mandatory audit firm rotation?" A substantial majority (71%) responded "no", 17% responded "yes", and 12% responded "not sure". The responses to this question are not surprising based upon on the 69% disagreement rate for Statement 7. In response to Question 2 "Do you support mandatory audit partner rotation?" over one-half (53%) responded "no", 29% responded "yes" and 18% respond "not sure". A careful review of the supplemental questions reveals that most of the chief officers do not support audit partner or audit firm rotation.

Comments

Finally, participants are asked to provide additional comments relating to audit partner and/or audit firm rotation. The majority of responses given were: too costly to implement a rotation policy, the learning curve for most nonprofits is lengthy, quality of the audit may suffer if done by a new auditor every five years. Additionally, some participants state that because many of the nonprofits are small with limited resources, the organization would not benefit by rotating audit partners or firms.

RECOMMENDATIONS AND FUTURE RESEARCH

This study clearly indicates that the chief officers did not support mandatory audit firm or partner rotation. The authors believe that chief officers recognize the importance of auditor independence in fact and appearance for NPOs. However, the chief officers did not believe that the cost of partner or firm rotation is worth the possible enhancement of auditor independence. Therefore, the authors recommend that the FASB and other NPOs stakeholders continue to examine the pros and cons of implementing partner and/or firm rotation(s). In addition, nonprofit organizations should examine more closely the advantages and disadvantages of auditor rotation without cost being the main deciding factor whether to implement such a policy. Although, some NPOs have implemented some provisions to strengthen their accountability and financial reporting, it appears there is still much work to be done to increase auditor independence in the NPO sector.

The results of this study are limited to the views of chief officers of NPOs that are required to have an independent audit conducted in accordance with the Single Audit Act. Future research can examine the views of chief executive and financial officers at other NPOs not subject to the Single Audit Act. Furthermore, it would be interesting to examine the views of other stakeholders (lenders, donors, etc.) of Nonprofit Organizations.

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APPENDIX

Table 1
Demographic Information of Respondents

	Count	Percentage
Group Size	100	100%
Education Level (Degree)		
Associate's	3	3%
Bachelor's	49	49%
Master's	44	44%
Doctorate's	4	4%
Total	100	100%
Current Title		
CFO	64	64%
CEO	16	16%
Other	20	20%
Total	100	100%
Nonprofit Experience (Years)		
Less than 5 years	16	16%
5 but less than 10 years	22	22%
10 but less than 15 years	13	13%
15 years and over	49	49%
Total	100	100%
Age		
Under 46	17	17%
46 to 55	35	35%
Over 55	48	48%

Table 1
Demographic Information of Respondents

Total	100	100%
Gender		
Male (Female)	58 (42)	58% (42%)

Table 2
Perceptions of Independence and Auditor Rotation

Statement	Mean (SD)	SD (1)	D (2)	N (3)	A (4)	SA (5)
1. Independence is the foundation of the independent audit for nonprofit organizations.	4.25 (.72)	.98%	.98%	7.85%	52.94%	37.25%
2. Independent auditors should be independent in “fact and appearance” for NPOs.	4.26 (.78)	1.96%	.98%	5.88%	50.98%	40.20%
3. The appearance of auditor independence is just as important as the auditor being independent in fact for nonprofit entities.	3.89 (1.02)	2.94%	9.8%	10.79%	48.04%	28.43%
4. Audit partner rotation will increase auditor independence.	2.76 (.98)	9.8%	32.35%	30.40%	26.47%	.98%
5. Audit firm rotation will increase auditor independence.	2.73 (1.05)	11.76%	34.31%	26.48%	24.51%	2.94%
6. Mandatory audit partner rotation should be required for nonprofit organizations.	2.77 (1.15)	14.71%	31.37%	19.61%	30.39%	3.92%
7. Mandatory audit firm rotation should be required for nonprofit organizations.	2.30 (1.19)	28.43%	40.20%	8.82%	17.65%	4.90%
8. Nonprofit organizations should be required to change audit partner every five years.	2.50 (1.05)	16.67%	41.18%	19.60%	20.59%	1.96%
9. Nonprofit organizations should be required to change audit firms every five years.	2.18 (1.00)	28.43%	39.22%	19.61%	11.76%	.98%
10. Nonprofit organizations should not voluntarily implement a policy of audit partner rotation.	3.06^{+} (1.03)	7.84%	27.45%	32.36%	27.45%	4.90%
11. Nonprofit organizations should not voluntarily implement a policy of audit firm rotation.	2.81^{+} (1.12)	6.86%	22.55%	27.46%	31.37%	11.76%

12. The cost of periodic rotation of audit partners would likely exceed the benefits for nonprofit organizations.	3.37 (1.07)	.98%	27.45%	19.61%	37.25%	14.71%
13. The cost of periodic rotation of audit firms would likely exceed the benefits for NPOs.	3.44 (1.23)	8.82%	18.63%	10.78%	43.14%	18.63%

[+]indicates the negatively-worded item mean score was reverse coded for consistency.

Table 3
Supplemental Question Analysis
Summary of Percentages

Question	**Yes**	**No**	**Not Sure**
1. Do you support mandatory audit firm rotation?	17%	71%	12%
2. Do you support mandatory audit partner rotation?	29%	53%	18%