

Audit partners' perspective:
Mandatory audit partner rotation in New Zealand

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Abstract

New Zealand mandated audit partner rotation regulations for New Zealand Exchange (NZX) entities in May 2004, since then audit partner rotation policies have been implemented for Financial Markets Conduct entities and entities overseen by the Office of the Auditor General. Time-on periods for engagement partners range from five to seven-year followed by a five-year cooling-off period. Rotation policies also apply to engagement quality control reviewers and other key audit partners. The multi-dimensional structure of rotation regulations that have been implemented aligns New Zealand with countries that have significantly larger populations and GDP's. The purpose of audit partner rotation is to reduce the 'familiarity threat' and increase independence between the engagement partner and client. The incoming audit partner should also bring a 'fresh perspective' to the engagement to increase audit quality and efficiencies. Using semi-structured interviews to conduct a qualitative study, the purpose of which is to discover how audit partners perceive mandatory audit partner rotation and what the implications are from transposing audit partner rotation regulations from large-scale economies to a small-scale economy. Fifteen interviewees were selected consisting of Big Four and non-Big Four audit partners. The research design for this study was to replicate a study done by Braun and Clark (2006) using thematic analysis to analyse the qualitative data and to document the real-life experiences of audit partners following a change to their realities. The key findings and conclusions from this study are that regulators have chosen to align New Zealand audit partner rotation policies to large-scale economies rather than 'right size' them to New Zealand's demographic environment. Audit partners perceive that mandatory audit partner rotation disproportionately disadvantage small to mid-sized audit firms due to limited audit partner resources. The implications of which has been that a number of small audit firms have left the registered audit firms market increasing market concentration. Extended cooling-off periods are the biggest challenge to audit firms

that may no longer be necessary due to significant changes occurring within client entities that naturally reduces the likelihood of a ‘familiarity threat’. An incoming audit partners ‘fresh perspective’ can be described as a critical reassessment of the material risks that threaten the entity and previous judgments made. Making audit partner rotation a governance issue for the entity and an audit quality increasing exercise. In response to imposed mandatory audit partner rotation, audit firms have implemented planning and coordination mechanisms to manage the implemented policies. The purpose of which is to retain institutional knowledge within the engagement, have audit team members present with knowledge of a client’s specific matters, and replace the engagement partner with an audit partner that has industry experience.

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Chapter 1: Introduction

1.1 Research background

This thesis is to investigate the imposition of mandatory audit partner rotation regulations in New Zealand. Rotation policies have been implemented in many countries based on the perception that longer engagement partner tenures result in a ‘familiarity threat’. The purpose of bringing in a new engagement partner is so that they will bring a ‘fresh perspective’ to the engagement, which is presumed to increase independence and objectivity (Dodgson et al. 2020). Between 2004 and 2014 a multi-dimensional system of audit partner rotation has been implemented for different entity types including extended cooling-off periods. This complex structure of rotation regulations aligns New Zealand with much larger countries that have significantly larger populations and gross domestic products (GDP). Research on audit partners rotation has predominantly been done countries with large commercial entities and large audit firms. Little is known about how mandatory audit partner rotation could affect a small-scale economy such as New Zealand. This research will provide evidence on the two research questions: First, how do audit partners perceive the imposition of mandatory audit partner rotation regulations? Second, what are the implications of mandatory audit partner rotation in New Zealand?

New Zealand has adopted trans-national audit partner rotation regulations. Complex multi-level regulations can create inherent tensions between different organisational actors such as Big Four and non-Big Four audit firms (Quack and Schuler, 2015). New Zealand commercial environment is made up of mainly small and mid-sized entities with a few large commercial entities (MYOB). Auditing larger complex entities requires increased audit partner resources to cover all the available roles (Stewart and Kinney, 2013). Extended cooling-off periods have described by practitioners as onerous (EY, 2018) and should only be implemented if they can be proven to increase audit quality (Mattock et al. 2022). The

question this raises, is whether trans-national audit partner rotation regulations are practical in New Zealand and are there different implications for Big Four and non-Big Four audit firms from implementing audit partner rotation regulations and extended cooling-off periods.

Audit partner rotation regulations and cooling-off periods have been transposed from much larger economies. Of importance to this study is how these implemented regulations fit into the New Zealand demographic environment. Some researchers argue against audit partner rotation because of the loss of client specific knowledge which could affect audit quality in the first few years of the engagement (Myers et al. 2003). Research has found that auditors with specialist industry experience outperform non-specialists in detecting errors (Knechel et al. 2013). To maintain audit quality, audit firms need to replace the incumbent audit partner with an incoming audit partner with specialist industry experience. Which makes audit partner rotation an audit partner resource issue for audit firms.

Dodgson et al. (2020) researched audit partner transitions discovering that audit firms use ‘relationship manager’ and that senior audit partners are involved in the transition. Pittman et al. (2022) suggests that audit firms train an incoming partner into the engagements partner’s position. Sharma et al. (2017) found that audit firms incur increased costs around rotation. What can be interpreted from this research evidence, is that audit firms apply resources to the management of audit partner rotation. Research does not provide answers to how audit firms manage audit partner rotation. This research will investigate how audit firms manage the imposition of audit partner rotation in New Zealand.

The multi-dimensional structure of audit partner rotation regulations indicates that audit firms will have to manage their human resource capital. Human resource management provides literature on how organisation can implement matrixes and rosters for the efficient allocation of human resources (Rogstadius et al. 2011). Audit firms focus on replacing engagement partners with industry specific knowledge (Arthur et al. 2017). An organisation

internal policies should include managing the collective knowledge of their employees to fulfil the needs of their clients (Baird and Meshoulam, 1988). This research will suggest a practical framework for audit firms in small-scale economies to manage audit partner rotation.

Auditor-client relationships are complex, engagement partners need to facilitate the transference of information from the client to complete a quality audit. Yet, challenge the management of the entity on the key assumptions and judgements they have made in auditor negotiations (Beattie et al. 2000). The extent of this challenge is dependent on whether the engagement partner determines the judgement to be a material risk to the entity. Auditor negotiations can result in conflicts between the engagement partner and management of the entity around material risks to the entity. The primary relationship between an auditor and client is critical to securing a quality outcome (Beattie et al. 2004). Audit partner rotation periodically ends the auditor client relationship. Little is known about how audit partner rotation impacts auditor negotiations in the first few years of an engagement partners tenure, which motivates the researcher to investigate this issue.

Lennox et al. (2014) researched audit partner rotation, finding that the incoming audit partner conducts a peer reviews of the incumbents' assumptions and judgments. In 2015 the International Auditing and Assurance Standards Board (IAASB) required that the name of the engagement partner to be included in the auditor's report for listed entities. This regulation means investors can track an engagement partner history. The Audit regulations Act 2011 allows the Financial Markets Authority (FMA) in conjunction with CAANZ to commence civil or criminal prosecutions against audit partners in the event of an audit failure or corporate collapse. The implications of this for the individual audit partner is that they share litigation responsibilities with the audit firm. These two regulations increase the internal

challenges between audit partners. This research will look to discover how these regulations impacts auditors' internal relationships.

1.2 Research Problem

Audit partner rotation became a prominent issue in research after the US House of Representatives passed the Sarbanes Oxley Act 2002 (SOX). The motivation for passing this act was a number of significant frauds that took place between the late 1990's and early 2000's (e.g., Enron, WorldCom, Tyco, Waste Management). The purpose of this act was to enhance the public confidence in governance and auditing of US public companies (Coates, 2007; Romano, 2004). Section 203 of the SOX required the engagement partner and concurring partner to rotate every five years followed by a cooling-off period of five years for Securities Exchange Commission (SEC) companies (US House of Representative, 2002).

Within two years of the SOX being passed the UK, Australia, Canada and New Zealand all followed suit introducing audit partner rotation requirements. Before the introduction of audit partner rotation New Zealand audit partners were able to carry out engagements on a continuous basis. What was stipulated by the New Zealand Institute of Chartered Accountants (NZICA) was that audit companies were required to consider a long association of personnel (including audit partners) with an audit client.

In adopting audit partner rotation regulations, New Zealand is essentially keeping in line with major capital markets overseas and ensuring that the quality of New Zealand's financial reporting is compatible to leading practices in the world. There are undoubtedly benefits to adopting international auditing standards, the problematic question is whether the benefits of implementing international regulations outweigh the costs. Audit firms in New Zealand can be described as comparatively small but highly developed (Johnson et al. 1995) which patently effects the amount of audit partners available for rotation with the relevant experience and skills to conduct specialist audits.

1.3 Research Objective

The objective of this research is to contribute to the body of knowledge in this area by interpreting the lived experiences of licensed audit partners in New Zealand. Its purpose is to discover how audit partners perceive these regulatory changes and what the implications are to a small-scale economy such as New Zealand. This is an exploratory study that is looking to gain the perceptions of audit partners on how regulations are affecting the industry. By providing direct evidence from audit partners, this study aims to provide useful information to regulators on the effectiveness of the regulation they have imposed and the audit regime they have constructed.

1.4 Statement of research question

New Zealand has implemented audit partner rotation regulations in line with world leading security markets. To understand how mandatory audit partner rotation in New Zealand affect audit partners work and life, we ask our first research question.

RQ1: How do audit partners perceive the imposition of mandatory audit partner rotation regulations?

The countries New Zealand's has aligned itself with have significant larger commercial entities and audit firms. To understand the affects this has on New Zealand audit partners and firms, we ask our second research question.

RQ1: What are the implications of mandatory audit partner rotation in New Zealand?

To investigate these issues, the researchers conducted Thirteen semi-structured interviews with Big Four and non-Big Four audit partners. By using a qualitative methods, the researcher was able to have in-depth conversations with participants to gain an understanding of how audit partners perceived the implemented regulations (Ogharanduk et al. 2016). This is an inductive explorative study which seeks to discover binding principles to

construct generalisations. Thematic analysis can be a constructionist method that examines the way in which events, realities, meanings, and experiences can reflect changing social realities. By using thematic analysis to analyse the data, the researcher can interpret the meanings of experiences to discover the implications that audit partner rotation has had on audit partners and firms (Braun and Clark, 2006).

The key findings from this study were that audit partner rotation disproportionately disadvantaged small to mid-sized audit firms due to limited partner resources forcing them to merge or leave the domestically registered audit market. Some consumers of audit services have also been disadvantaged due to the increased market concentration that audit partner rotation has caused. Extended cooling-off periods were perceived as posing the biggest challenge to New Zealand audit firms. Audit partners from Big Four audit firms provided qualitative research evidence that there are only a few audit partners in New Zealand capable of auditing a large complex entities, which implies reduced audit quality from audit partner rotation regulations. Audit firms have constructed matrixes to manage the multi-dimensional structure of audit partners rotation, to retain institutional knowledge, and provide an audit partner with industry experience. Rotation regulations have a negative effect on auditor-client relationships and negotiations in the first year of the engagement. The ‘fresh perspective’ has a positive affect with the incoming audit partner providing a fresh challenge to management in the second year of the engagement.

Audit partners perceive that audit partner rotation regulations should be ‘right sized’ to the New Zealand demographic environment and that regulators were implementing regulations into New Zealand that are designed for large international economies. This represents a disconnect between how audit partners perceive regulators should be implementing regulations to how regulations are actually being implemented. The biggest problem for New Zealand audit firms were cooling-off periods, which may no longer be

necessary due to employees in client entities constantly changing. Audit partners perceive that audit partner rotation makes them more reliant on the audit managers and team relationships as well as their knowledge of client specific matters. The practical reality is that audit partner rotation becomes a resource issue in a small-scale economy such as New Zealand, disproportionately affecting small and mid-sized audit firms. The implications of audit partner rotation are that audit firms need to increase their audit partner resources to provide services to their clients. Audit firms construct matrixes to provide audit partners with industry experience and maintain audit quality. For Big Four audit firms, rotation regulations mean not being able to provide the most suitable audit partner, while some non-Big Four audit firms struggle to provide audit partners services for certain engagements.

This research contributes to literature by providing qualitative research evidence on audit partner rotation regulations being transposed for large-scale economies to small-scale economies. A key finding was that regulators should consider a countries demographic environment before implementing regulations and ‘right size’ them to the resources available to the audit firm. This research contributes to knowledge by providing planning and coordination mechanisms for audit firms to manage audit partner rotation. Another contribution to knowledge was that audit partner rotation increases the challenge to management in the second year of the engagement by providing a ‘fresh perspective’ that can be considered a critical reassessment of the material risks that threaten the entity and previous judgments made, making audit partner rotation a governance issue for the entity.

1.5 Structure of thesis

Following the introduction chapter, Chapter 2 contains the literature review which: Firstly, gives an overview of the regulations imposed. Secondly, matches prior research to the identified themes discovered in this research. Chapter 3 covers the methodologies and methods undertaken in this thesis and will including methods, paradigms, research design,

interview design, interview question, data collection and analysis. Chapter 4 presents the findings from this research, which is split into three central topics: Firstly, Implications of audit partner rotation on audit practice in New Zealand. Secondly, Planning and coordination mechanisms. Thirdly, relationships between engagement partners and their clients. Chapter 5, then discusses and interprets the findings from this study on the three central topics. Chapter 6 concludes this study by providing conclusions that answer the research question, contributions to practice, recommendations for future research, and limitations that have affected this research.

Chapter 2: Literature review

2.1 Introduction

Interviews were conducted with fifteen audit partners across New Zealand. In inductively analysing the qualitative data, a number of consistent themes were identified of being important to audit partners. The purpose of this literature review is to provide an overview of the existing literature and provide background information on the major themes expressed by audit partners. The first section of this chapter will present an overview on the regulations that have been imposed on audit partners. The second section will provide a summary of the relevant literature to audit partner rotation and the identified themes.

Through this literature review, topics will be assessed for their potential implications to audit quality. The methods and methodologies of specific pieces of literature that closely aligns to the research topics will be critically disseminated for their relevance in answering the research question. By doing this, this literature review will provide an information background to be expanded on in the findings and discussions chapter of this research.

2.2 Regulating audit partner rotation

Audit partner rotation has been implemented in many countries around the world. Following the introduction of the SOX in the US, New Zealand, Canada, UK, and Australia all followed suite implementing the same rules, interestingly in 2010 Canada changed its five-year rotation regulation back to seven-years for the engagement partner of listed countries (Daugherty et al. 2012). The European Union in response to the financial crisis brought in audit firm rotation regulations as well as audit partner rotation regulations, though a number of its member states already had audit partner rotation regulations in place. Under Directive 2014/56/EU and Regulation (EU) No. 537/2014 audit partner rotation would be mandated at seven-years followed by a cooling-off period of three-years. Which incidentally were the rules that the UK, US, and Canada had in place before the SOX was passed. The

European Union has a diverse range of countries in it with population rates ranging from 441,543 in Malta to 83,783,942 in Germany, the average populations per country is 11,817,542 with the medium population being 7,977,422. New Zealand more closely resembles a number of countries in European Union by population than it resembles the UK, Canada, Australia and US. A comparison of regulations is presented in the table below to show how regulations have been aligned between the countries.

Table 1: *Cross Country audit partner rotation regulations*

Country/ Union	Legislation	Reason	Regulation
US	Sarbanes-Oxley Act 2002	Was passed mainly in response to the corporate scandals of the Dot-com-era	The engagement partner and concurring partner to rotate every five years followed a cooling-off period of five years for listed companies
UK	Auditing Practices Board Ethical Standard 3 for rotation.	After the fall of Enron the UK set up the (GCAA) co-ordinated group of auditing and accounting	The engagement partner and EQCR to rotate every five years followed a cooling-off period of five years.
Canada	Independence – Long Association (Rule 204.4 (20))	In recognition that a long association may create a familiarity threat	The engagement partner and EQCR to rotate every five years followed a cooling-off period of five years for reporting issuers and listed entities.
European Union	Directive 2014/56/EU and Regulation (EU) No. 537/2014	In response to the 2007-2008 Financial crisis the European union commission The Green Paper	The audit partner to be rotated every seven-years followed by a three-year cooling off period.
Australia	Section 290 and 291 of APES 110 Code of Ethics for Professional Accountants.	That there is a diminution in the quality of audits after associated with long audit partner tenure.	The engagement partner and EQCR to rotate every five years followed a cooling-off period of five years.
New Zealand	PES 1 for FMC entities. Listing rule 2.13.3 (f) for NZX companies and AG PES 1 Code of Ethics	New Zealand passed audit partner regulations to keep in line with its trading partners	The engagement partner and EQCR to rotate every five years followed a cooling-off period of five years for NZX companies.

Audit partner rotation regulation were initially imposed on NZX entities in May 2004 under listing rule 2.13.3 (f). Since then, engagement partners, engagement quality control reviewer (EQCR) and other key audit partners have had numerous regulations placed upon them affecting their social reality and work-life balance. This section of the chapter will: Firstly, define the roles of auditors that are subject to audit partner requirement. Secondly, present the specific audit partner rotation time frames that audit partners must adhere to, and thirdly, provide contextual information useful to the readers of this thesis.

The *engagement partner* is the person that has been appointed by the audit firm to the client to perform the task of completing an audit. An *engagement partner* is the person responsible for the effective function of all phases in the audit and for exercising their professional judgment (Lawinsider), an interchangeable term for the *engagement partner* is *audit partner*. In large client audits the engagement partner can be in charge of several audit partners, audit managers and audit team members (Stewart and Kinney, 2013). The *engagement partner* is responsible for providing an opinion on the consolidated financial statements that may include a number of subsidiaries. Along with the engagement quality control reviewer (EQCR) and other senior audit staff, the *engagement partner* is responsible for identifying the material threats to the entity and challenging the assumptions and judgements made by the entity. They are the person that has the appropriate authority from a professional, legal or regulatory body (IESBA, 2007: XRB, 2011).

The XRB (2011), describe engagement quality control review as a process designed to provide an objective evaluation, of the significant judgements made by the engagement team and the conclusions it has reached in formulating the auditor's report. The EQCR is the person that conducts the engagement quality control review. EQCR's review selected working papers relating to significant judgements made by the engagement team and evaluate conclusions made for their appropriateness assessing the audit high-risk transactions and

account balances. The review procedure should involve a discussions between the engagement partner and EQCR on any significant matters, that no matters arising breach generally accepted accounting principles and ensure there are no matters outstanding. The engagement partner is required to gain EQCR approval before the issuance of an audit opinion. An EQCR should not be considered part of the audit team but as a quality control mechanism to provide reasonable assurance.

The International Ethics Standards Board for Accountant (IESBA) define an '*other key audit partner*' as a person that conducts an audit of a subsidiary or division within an entity. As opposed to the engagement partner who is responsible for the 'group' and consolidated financial statements, the '*other key audit partner*' is responsible for the subsidiaries or divisions financial statements that will become part of consolidated financial accounts. This person may work independently of the engagement partner, essentially conducting an audit of stand-alone entity with a separate audit manager and audit team working under them. They do however report directly to the engagement partner. This person takes responsibility for the key decisions on significant judgements matters and is expected to have an in-depth knowledge of the industry they are auditing because a lack of knowledge presents a threat to audit quality (IESBA, 2007).

The key provisions of the Auditor Regulation ACT 2011 require the auditor of an FMC reporting entity to be licensed and the audit firms to be registered. The term 'auditor' refers to the engagement partner and EQCR who are both required to be licensed to complete an FMC audit (Section 8, 1). To be a registered audit firm, the firm must have at least one licensed auditor, it is the responsibility of the audit firm is to ensure that the engagement partner and EQCR performing an FMC audit are licensed (Section 9, 2). To become a licensed auditor, the auditor must first have their personal qualifications recognised by the company's office which includes having five years of audit experience and 3000 hours of

audit work immediately prior to applying for a license, 750 of these hours must be spent auditing an NZX or FMC entity (FMA, 2020).

The engagement partner and EQCR must also adhere to External Reporting Board (XRB) requirements, PES 1. This means that an engagement partner and EQCR must be licensed to carry out NZX audits, and similarly for OAG entities, under AG PES 1 Code of Ethics. Section 78 of the Auditor Regulation ACT 2011 gives the FMA powers to suspend or cancel an auditor's license. Under part 1 of the preliminary provisions, the FMA has the power to gather certain general information, issue fines and demand reimbursement for costs incurred in investigations. Criminal or civil proceeding are carried out in conjunction with the auditor's professional membership bodies. The passing of The Financial Markets Conduct Act 2013 introduced a system of de-escalating levels of liabilities and a new set of regulatory powers and infringement offences which increased the emphasis on civil liabilities for contraventions, reserving criminal proceeding for the most serious violations (O'Niel, 2015).

In 2015 the International Auditing and Assurance Standards Board (IAASB) through their Enhanced Reporting Requirements, requires engagement partners to sign the audit opinion a provision. This requirement was already in place in the US and has now been implemented in the UK, Canada, New Zealand and Australia for issuer audits. The defined purpose for this initiative is it allows investors to track an audit partners history relating to industry experience, restatements, involvement in disciplinary proceedings and litigation. This gives investors and stakeholders a better understandings of potential risks associated with the audit (Goelzer, 2019). The accounting profession responded by pointing out that this could deter audit partners from accepting riskier clients (Christensen et al. 2021). The regulations that have been imposed on audit partners in New Zealand are presented in the table below.

Table 2: *Audit partner legislation in New Zealand*

May 2004	NZX makes audit partner rotation mandatory requiring the key audit partners to rotate every five years. The definition of the key audit partner in the rules has the meaning given in the External Reporting Board Professional Code of Ethics PES (1) revised.
May 2011	Financial Markets Authority Act 2011, part 1 preliminary provisions (a) establish the Financial Markets Authority as an independent crown entity (c) provide the Financial Markets Authority to have certain general information–gathering and enforcement powers.
May 2011	Auditors Regulation Act 2011, (5) Functions under this act (e) to conduct quality reviews and investigations under subpart 6 and 7 of part 2: Section 8 – Auditors in respect of FMC audits must be licensed (1) Every natural person who acts as the auditor in respect of a FMC audit must hold a license. (e) to conduct quality reviews and investigations under subpart 6 and 7 of part 2:
January 2014	Professional and Ethical Standard 1 (Revised). Definition, key audit partner: The engagement partner, the individual responsible for the engagement quality control review, and other audit partners. 290.151 in respect to the audit and review of a public interest entity, an individual shall not be a key audit partner for more than seven years. After such time, the individual shall not be a member of the engagement team or be a key audit partner for the client for two years.
October 2015	Auditor Reporting Enhancements. Additional independence statement: The IAASB requires, for auditor reports of listed entities, that the auditors’ responsibilities paragraph include a statement that the auditor is required to disclose to those charged with governance all relationships and other matters that may be reasonably be thought to bear on the auditor’s independence. Engagement partners name (19): The IAASB requires that the name of the engagement partners be included in the auditor’s report for listed entities.
January 2018	Professional and Ethical Standard 1 (Revised). 290.155 If the individual acted as the engagement partner for seven cumulative years, the cooling–off period shall be five consecutive years. 290.156 Where the individual has been responsible for the engagement quality control review and has acted in that capacity for seven cumulative years, the cooling off period shall be a period of three consecutive years.

The initial audit partner rotation regulations were for audit partners that audited NZX listed companies. NZX Listing rule 2.13.3 (f) states that the *key audit partner* is changed at least every five–years. Under the Auditor Regulation Act 2011 this can be interpreted to

mean the engagement partner and EQCR. Cooling-off periods to be applied are found in the XRB PES 1, which requires an engagement partner to have a five-year cooling-off period and the EQCR to adhere to a three-year cooling-off period. Other key audit partners for NZX companies are required to rotate every five-years followed by a two-year cooling-off period.

Audit partner rotation requirements for FMC reporting entities are set out in PES 1. The criteria for a Tier 1 entity that the PES 1 applies to, can be described as both listed debt and equity issuers and include banks, insurers, credit unions and buildings societies etc that are not listed on New Zealand's stock exchange. For these entities the engagement partner is required to rotate every seven-years followed by a cooling-off period of five-years. The EQCR is required to rotate every seven-years followed by three-year cooling-off period. Other key audit partners are required to rotate every seven-years followed by a two-year cooling-off period. In 2018 the cooling-off period for EQCR's was extended from two-years to three.

The office of the Auditor General (OAG) is responsible for the audits of public entities. Examples of public entities include Ports, schools, government departments and tertiary education institutions etc which totals over four thousand entities. Audit New Zealand is the OAG preferred supplier, in addition to Audit New Zealand the OAG outsources audit work to sixty-one external audit service providers to carry out audit services and engagements. For these outsourced audits the OAG conducts performance reviews on the audited services that have been provided. For OAG entities the engagement partner is required to rotate six-years followed by a cooling-off period of five-years, EQCR's are required to rotate every six-years followed by three-year cooling-off period. Other key audit partners are required to rotate every six-years followed by cooling-off period of two-years (OAG, 2004). Table 3 presents the myriad of different audit partner rotation regulations that have been implemented in New Zealand.

Table 3: *Rotation Requirements for New Zealand Entities*

Entity Type	Engagement partner		EQCR		Other Key audit partner roles	
	Time-on	Cooling-Off	Time-on	Colling-Off	Time-on	Cooling-off
NZX Listed Entities	5 Years	5 Years	5 Years	3 Years	5 Years	2 Years
FMC Reporting Entities	7 Years	5 Years	7 Years	3 Years	7 Years	2 Years
Office of the Auditor General	6 Years	5 Years	6 Years	3 Years	6 Years	2 Years
Note 1: Time on, refers to the maximum cumulative years an audit partner may serve in an engagement.						
Note 2: Cooling-Off, refers to a minimum consecutive period where a key audit partner shall not be involved with the entity in any professional capacity.						

Audit firms are managed by a group of senior auditors that are usually led by a managing partner. That person is responsible for allocating audit partners to clients and managing their portfolios (Lennox et al. 2023). (Dodgson et al. (2020) provides an extrospective view of other members of the audit firm that are typically involved in the client engagement. Sector leaders are often involved in managing rotations internally for a complex client as is a national risk management group. Dodgson et al. (2020) also states that senior partners may have contact with the client during the rotation process and ‘relationship partners’ are often assigned to clients on a non-decision making basis. The extend of their involved isn’t known which presents an opportunity for future research, though extracting this information from audit firms may prove difficult.

2.3 Literature review – Audit partner rotation

The discussions with audit partners resulted in a number of themes being identified. Following an inductive study approach, relevant literature has been determined after the data

collection. The purpose of this literature review is to overview quantitative and qualitative research evidence on audit partner rotation regulations. Research evidence and regulatory perspectives will be matched to the identified themes in this research.

This section of the chapter will be set out as follows: Firstly, transposing regulations from large-scale economies to a small-scale economy. Secondly, audit firm tenure. Thirdly, familiarity and familiarity threat. Fourth, a fresh perspective. Fifth, internal controls. Sixth, the loss of client specific knowledge. Seventh, cooling-off periods. Eighth, auditor negotiation. Ninth, auditor transitions. Tenth, managing audit partner rotation.

2.3.1 Transposing regulations from large-scale economies to a small-scale economy

Of importance to this research is that New Zealand regulators have transposed audit partner rotation regulations from large-scale economies into a small-scale economy. In 2011 the New Zealand parliament passed legislation to establish the Financial Markets Authority (FMA) creating a regulatory regime to oversee the New Zealand audit market. In 2012 the FMA joined the International Forum of Independent Audit Regulators (IFIAR) who's purpose is to support regulatory regimes in coordinating international audit regulations and to give investors and other stakeholders confidence in a country's capital markets (FMA, 2012; IFIAR, 2020). The establishment of the FMA and joining the IFIAR aligned New Zealand with a number of its significant trading partners. The IFIAR strategic goal is to improve global audit quality to reassure capital market investors and currently has fifty-four members. The IFIAR encourages its members to adopt international audit regulations and provide specialist knowledge to support their implementation but does not appear to provide a framework for applying audit regulations into different sized economies. What this suggests is that international audit regulators do not consider size when designing regulations.

Rodrigo (2005) found that small countries when implementing regulations rely more on benchmarking, which implies that smaller countries apply regulations proportionate to the

size of their economy while larger countries rely more on empirical methods. Quack and Schuler, (2015) discuss how the implementation of regulations may have different implications for small and large firms. It should also be considered that larger organisations may seek regulations to their own advantage and lobby against regulations that could disadvantage them in the marketplace. Regulators supply information on how to implement regulations but little analysis has been done on effects of implementing regulations from large-scale economies to small-scale economies. Prompting more research into this subject area.

2.3.2 Audit partner tenure

Audit partner rotation restricts an engagement partner from carrying out an audit client engagements on a continuous basis. Carey and Simnet (2006) explain that the regulatory policy of audit partner rotation is based on the assumption that there will be a diminution in audit quality over the tenure of an engagement. The argument for limiting an audit partners tenure to a specific period of time is based on a perception that audit partners in longer tenures are less likely to challenge opportunistic management decisions, that a ‘familiarity threat’ will develop, which implies that audit partners may start to agree with management decisions, and that audit partners may sacrifice objectivity to retain a prestigious client (Carey & Simnet, 2006; Chi & Huang, 2005; Chi et al. 2009; Fitzgerald et al. 2018). What researcher and regulators suggest is that long tenures erode an audit partners capacity for critical appraisal. If that erosion leads to a reduction in audit quality or an audit failure then there will be an imposed cost to society and the profession (Carey & Simnett, 2006)

The above research and regulatory position could be considered to be at odds with capital market actor such as banks and insurance companies who associate long tenures with accuracy, credibility, and quality (Ball et al. 2008; Bharath et al. 2008; Kim et al. 2011). The argument is that auditors gain more experience from long tenure and are better able to

understand the financial choices made by management are proper (Chen et al. 2008). Myers et al. (2003) found that long tenure is associated to higher earnings quality and on average results in greater constraints on extreme management decisions. Why capital markets actors associate long tenures with accuracy and credibility is that the extent of earnings management is generally lower when auditor tenure is longer (Johnstone et al. 2002; Knechel & Vanstraelen, 2007). These researchers suggest that as an auditor gains more experience earnings quality increases because they are able to determine and constrain poor choices made by management.

Audit partner rotation has been made mandatory in many countries based on the assumption that longer tenures reduce independence and objectivity (Carey and Simnett, 2006; Chen et al. 2008). Proponents for mandatory audit partner rotation argue that “limiting auditor tenure reduces concerns about deteriorating independence and audit quality” (Myers et al. 2003, pg. 781). Consistent with the regulatory view, Mautz and Sharaf (1961) suggest that extended auditor client relationships may have a deteriorating effect on independence which can be attributed to a reduction in the auditor’s objectivity of a client in longer engagements. The intent of mandatory audit partner rotation is that the incoming audit partner will provide a ‘fresh perspective’ of the engagement which is presumed to increase independence and objectivity (Dodgson et al. 2020). Prior research suggests that mandatory audit partner rotation improves independence which positively effects audit quality (Daugherty et al. 2012).

2.3.3 Familiarity and familiarity threat

Mautz and Sharaf (1961) state that auditors must be aware of both obvious and subtle pressures, which can act as a slow, gradual, erosion of an auditor’s ability to remain sceptical in the audit engagement. The American Institute of Certified Public Accountants (AICPA) code of professional conduct developed a construct that would be termed a “familiarity

threat” offering the definition that implies “that due to a long or close relationship with a person or an employing organisation, a member will become too sympathetic to their interest or to accepting of the persons work or employing organisation product or service” (AICPA, 2015, p.24). Researchers have found that over familiarity between an engagement partner and a client can decrease an auditor’s willingness to challenge management on an aggressive financial position when auditing the financial statements (Chia-ah & Karlson, 2010). The acquiesce of an auditor to a clients–preferred position can be supported by a large body of knowledge in social psychology finding that social identification can significantly affect an individual’s behaviour, resulting in a change of attitudes and behaviours (Ellemers et al. 2002; Hogg and Terry, 2000; Riketta, 2005). Regulators perceive that in long tenures engagement partners will start to socially identify with a client’s opinions. Should that be an aggressive financial position, due to a long association the engagement partner will acquiesce to that position resulting in the financial statements being misstated.

The counter argument to long tenures leading to the financial statements being misstated is that an audit failure is more likely to occur early in the auditor–client relationship, when the auditor is less familiar with the client’s processes and risk (Myers et al, 2005). Such failures may be attributable to the period when an incoming engagement partner is building up knowledge and experience (Daugherty et al. 2012). In this period the incoming engagement partner lacks the knowledge and experience to challenge management on potential misstatements found in the audit, which could reduce audit quality (Abbot et al. 2000). In mandating audit partner rotation, regulators may perceive over familiarity to be a greater threat to audit quality than the loss of client specific knowledge and experience.

Research contends that audit quality improves with long tenure as the auditor becomes more competent gaining client specific knowledge and specialization within the industry (Garcia–Blandon and Argiles, 2017; Carcello and Nagy, 2004). Audit firms have been organizing

themselves along industry lines reflecting a belief that industry specialization leads to higher quality audits. It is also motivated by a propensity of audit committees to select industry–specialist auditors (Abbott and Parker, 2000). Hammersley (2006) conducts research to determine if auditors with unique industry–specialist knowledge, allows them to detect misstatements. The method for his research is an experiment instrument that contains two cases from different industries to assess the effects of industry specialist knowledge on performance with sixty–five designated industry specialists taking part. Findings from this study suggest that industry specialisation improves audit quality. What can be interpreted from this research is that changing the audit partner could be threat to audit quality if they are not replaced by an audit partner with specialist knowledge.

Regulators perceive over familiarity between the engagement partner and client to be threat to independence and audit quality. This current study posits that familiarity of an entities systems and processes can reduce the audit risk (Carey and Simnett, 2006). Audit firms and engagement partners must control for sized and complexity in an engagement. Dodgson et al. (2020) qualitative research evidence confirms that audit firms apply more resources to complex audits such as assigning a ‘relationship partner’ and having senior partner involvement at the executive level. During the planning stage of an audit engagement, partners plan evidence collection based on incomplete information. In a complex audit, individual auditors collect information and run tests on only one division of the audit and don’t have enough information on their own to identify if the financial statements are misstated (Hammersley, 2006). For a large entity the number of transactions can add an extra layer of complexity to this process (Werner and Gehrke, 2015). This makes the workload of the engagement partner more onerous having to judge whether the patterns of transactional data from multiple divisions constitute the financial statements being misstated. Complexity and the loss of client specific knowledge represent a threat to investors that the financial

statements might be misstated when the engagement partner is in first few years of an engagement. Which emphasizes the need for information's sharing between engagement partners so that the incoming audit partner is familiar with the transactional history of the entity.

2.3.4 A fresh perspective

The expectation of regulators in implementing mandatory audit partner rotation is that the incoming engagement partner will bring a 'fresh perspective' to the audit engagement (AICPA, 2011; Carey & Simnet, 2006; Chi & Huang, 2005; Lennox et al. 2014; PCAOB, 2011; Winn, 2021) and reduce familiarity between the auditor and client (Carey & Simnet, 2006; Chi & Huang, 2005; Daugherty et al. 2012; Lennox et al. 2014). A benefit to audit partner rotation is the sharing of knowledge between audit partners which can result in increased efficacies as audit partners peer review each other's work (Dodgson et al. 2020; Gue'nin-Paracini et al. 2015; Lennox et al. 2014). What is disputed is whether shorter or longer relationships between audit partners and their clients increases or decreases an audit partners ability to challenge a client when they have taken an aggressive financial positive. Prior research states that in the first year of an audit engagement the audit partner is less likely to be able to challenge management on complex issues in the financial statements, regulators are therefore relying on audit quality increasing in subsequent engagements based on audit partners sharing their knowledge and experience as they transfer from one client to another collectively increasing their individual knowledge base and the firms.

From a client's perspective audit partner rotation ensures that the critical judgements made by auditors are the correct ones. Each rotation results in a re-examination of the treatments of accounting standards by the entity. This re-examination inevitably reassures the client that the treatment of the accounting standards has been appropriately interpreted, especially when management have multiple interpretive alternatives at their discretion giving

them the opportunity to manage earnings (Barth et al. 2008). The identifiable problem is whether an engagement partner in a longer tenure with client-specific knowledge is more likely to confront management on their interpretations of accounting standards. Social psychology asserts the view that longer tenures result in behavioural change. Regulators negatively interpret this sociological perspective when defining a ‘familiarity threat’ yet ‘trust’ in social psychology is a determining factor for increasing communications. Wilson et al. (2017) conducts research into audit firm tenure, familiarity and trust. The method was to construct an experiment using respondents as proxies for entry-level employees, finding that auditor familiarity increases trust, which in turn, increases an employee’s or associate’s propensity to risk communicating an opinion. This research perspective implies that as trust develops in long relationships the engagement partner is more likely to challenge management on an aggressive accounting decisions (Simpson, 2005).

Research identifies that there are direct costs associated to implementing audit partner rotation and gaining a ‘fresh perspective’. These costs are associated to inefficiencies as the new partner builds up knowledge and experience (Sharma et al. 2017). Dodgson et al. (2020) found that audit firms apply more resources in the initial years of the audit engagement. Research does not provide answers to the extent of additional costs and resources applied to rotating audit partners. What can be assumed is that, though the audit partner has been rotated the audit firm’s methodology, procedures, and other engagement personnel do not necessarily change (Bamber and Bamber, 2009; Chi et al. 2009; Bedard and Johnston, 2010). Whether audit partner rotation increases audit quality is still being debated. Lennox et al. (2014) studied mandatory audit partner rotation in China, finding that audit adjustments occur more often in the incoming engagement partners first year, consistent with the ideology of a ‘fresh perspective’ and that the incoming engagement partner has conducted a peer review of the incumbent audit and corrected any financial reporting problems. This study indicates that

audit partners experience increased workloads in the initial year of an engagement, which can increase the costs of audit partner rotation to the audit firm.

2.3.5 Internal controls

Before audit partner rotation was made mandatory audit firms were using their own internal controls systems to mitigate the risk of a long association of personal (XRB, 2018). The risks outlined in research is that in longer tenures audit partners are less likely to challenge management on opportunistic management decisions. The purpose of a ‘fresh perspective’ is so that the incoming audit partner reassesses the material threats to the entity and judgments made (Daugherty et al. 2012). Which indicates that an audit firms internal control procedures for managing a long association of personal could be to have another external auditors conduct a material risk assessment of the potential threats an entity faces.

International Auditing and Assurance Standards Board (IAASB) required that the name of the engagement partner to be included in the auditor’s report for listed entities. The Audit regulations Act 2011 allows the Financial Markets Authority (FMA) in conjunction with CAANZ to commence civil or criminal prosecutions against audit partners in the event of an audit failure or corporate collapse. To interpret how these two regulations could affect the individual audit partner in the event of an audit failure or corporate collapse, the engagement partner is isolated by having to share litigation responsibilities with the audit firms and suffering significant individual reputational damage if proven to be legally liable. Which motivates the audit partner to ensure that the financial statements do not contain any material misstatements.

Lennox et al. (2014) describes how the incoming audit partner peer reviews the incumbents’ assumptions and judgements. The legal framework that has been implemented on audit partners increases the internal challenges between incoming audit partners and incumbents. (He et al. 2015) researched the reputational damage audit partners can suffer

after corporate collapse. Finding that audit partners associated to large corporate collapses can struggle to gain employment with reputable audit firms. Which suggests that audit partners are less likely to succumb to internal pressures from the audit firm or senior audit partners to except judgments they consider material because of the individual consequences they face.

The engagement quality control review is an internal objective evaluation of the significant judgements made by the engagement team. The engagement quality control reviewer (EQCR) is the person delegated to conduct that review and should have sufficient and appropriate experience and authority to objectively evaluate the conclusions made by the audit team in formulating the audit report (ISA 220). NZX and FMC audits require the engagement partner and EQCR to be licensed audit partners. The engagement quality control review must be completed before the audit report is issued. The EQCR should discuss significant matters arising during the audit to improve audit risk judgements. The purpose of which is to induce engagement partners to conduct higher levels of testing (Bedard et al. 2008). Beattie et al. (2004) suggests that audit firms should be aware of age and experience differences between engagement partners and members of the management of the entity. It stands to reason that the EQCR should be of a similar age and experience levels as the engagement partner to competently discuss matters arising in the audit.

2.3.6 The loss of client specific knowledge

Regulators in mandating audit partner rotation assume an interchangeable supply of audit partners with the relevant industry experience. It is assessed by professional bodies around the globe that industry expertise is an important factor when selecting an auditor (Abbott and Parker, 2000). Audit partners with industry specialisation can be considered to outperform non-specialists in detecting errors when performing analysis (Knechel et al.

2013; Messier et al. 2008). Arthur et al. (2017) researches the effects of audit partner rotation on audit quality and whether industry specialisation moderates such a relationship. The method for this study was to use discretionary accruals and audit fees as proxies for audit quality. Findings from this study would indicate that audit quality deteriorates unless the audit partner was replaced by an audit partner with specialist experience. Hogan and Jeter, (1999) observed that audit firms have trended towards providing specialist industry knowledge with the aim of providing higher quality audits to specific industries since the 1990's. Arthur et al. (2017) study concluded that audit partner specialisation combined with audit firm specialisation has a moderating effect on audit quality, which is support evidence from (Daugherty et al. 2012; Litt et al. 2014) that audit firm specialisation mitigates the effects of audit partner rotation. Research suggests that audit firms can minimise the effects of audit partner rotation by becoming industry specialists.

From an audit partners perspective, audit partner rotation also assumes an interchangeable supply of audit clients. Audit partners that specialise in banks and insurance companies for example, could be faced with having to relocate or retrain from not having a similar client to rotate onto when their rotation falls due, retraining in this instance may be within the audit firm and could affect audit partners position of prestige (Daugherty et al. 2012). Chi et al. (2012) studied audit partner rotation in Taiwan. Taiwan provides a unique setting for studying audit partner rotation because its financial reporting regulations require two audit partners to sign the audit report. Chi et al. (2012) raised a number of significant issues in relation to audit partner rotation and their ability to remain independent in the audit engagement process such as: job security, promotion opportunities, interorganisational power, and that the retention of an important client may be more beneficial at a partner level than at the audit firm level. The regulatory problem in New Zealand is that audit partners in remote location may have been carrying out engagements indefinitely, and that the

engagement partner may be financially dependent on the audit client. By implementing audit partner rotation, regulators are ensuring that engagement partners will not become dependent on individual clients.

2.3.7 Cooling-off periods

Following an audit engagement in New Zealand the engagement partner is required to observe a minimum number of consecutive years away from the audit before they are allowed to rotate back (Mattock et al. 2022). Section 290.164 (b) of PES 1 states that for the duration of the cooling-off period the individual shall not consult with the engagement team or client regarding technical or industry specific issues, transactions or events. This directive from the XRB inhibits the exiting engagement partner from being able to provide any expert knowledge to the new engagement partner once they have exited the engagement. What is not covered by regulations is that before the incoming audit partners becomes the engagement partner the incumbent audit partner is able to transfer knowledge of a client's specific matters.

Mattock et al. (2022) discusses how cooling-off periods result in the engagement partner losing client specific knowledge should they be rotated back on to the client. Suggesting that the longer the cooling-off period the more client specific knowledge is lost, but only if the audit partner is to rotate back onto the entity. Ernst & Young, (2018) questioned the relevance of cooling-off periods because there is no evidence to suggest that extended cooling-off periods increases audit quality. Mattock et al.'s (2022) study provides research evidence that extended cooling-off periods marginally increases audit quality. There is very little research evidence on the effects of extended cooling-off periods and regulators do not provide specific reasons for there implementation.

Audit partner rotation regulations were first introduced in New Zealand in 2004 which is now nearly nineteen years ago. Through this period of time there has been a generational

change in the workplace from Generation X to Millennials (Adkins, 2023). Millennials are being referred to as the job-hopping generation, staying on average less than five-years with an employer (Martic, 2023). The US Department of Statistics confirms that employees on average spend less than five-years with employers. The 2018 employer survey in New Zealand found that 38% of employees had spent more than five-years with their employer (StatsNZ). What this indicates is that there is less likelihood of a ‘familiarity threat’ developing between an engagement partner and a client and brings into question extended cooling-off periods because employees are spending less time with employers.

2.3.8 Auditor negotiations

The apotheosis moment in an audit frequently occurs in auditor client negotiations. Negotiations generally involve senior members of the audit engagement team, representatives of the entity members and the audit committee. In auditor client negotiations the engagement team will look to challenge the key assumptions and judgments that have been made by the management of the entity. The critical issue is whether managements’ interpretation of accounting standards could pose a material threat to the entity. The engagement partner, EQCR and senior members of the audit team have to decide if the assumptions made by management constitute the entity taking an overly aggressive position in the financial statements. Based the material risk assessment carried out by the engagement partner and audit team, the senior members of the audit team may have to concertedly challenge the management of the company till the engagement partner is comfortable issuing an unqualified audit opinion.

Beattie et al. (2000) researched the interactions between the two primary actors in the auditor–client relationship, the finance directors and audit engagement partner. Findings from this study are that: compliance issues dominate discussions, accounting and fee issues dominate negotiations, audit committees decrease negotiations and increase discussions and

most interestingly, in the majority of cases negotiations result in a change to the financial statements. This research identifies a tripartite of actors in auditor-client negotiations. The finance director putting forward an aggressive opportunistic financial position, the engagement partner looking to constrain any earnings management and the audit committee acting as an intermediary to work towards a negotiated outcome. The results of this study motivated Beattie et al. to conduct a further qualitative study interviewing finance directors and engagement partners. Beattie et al. (2004) study revolved around the research question “how do companies and their auditors resolve important audit issues?” focusing on what role auditors play in preventing an overly aggressive financial position? Findings from this study highlighted the importance of the engagement partner to act with integrity and that the primary relationship is critical to securing a quality outcome. The first study highlighted the importance of an audit engagement team being able to remain independent when going into a negotiated settlement. What was a little disturbing was that an auditor’s fees were discussed in these negotiated settlement which could be levered against the auditors to accept an aggressive financial position. The conclusions in Beattie et al.’s (2004) study highlighted the potential for an age or experience power imbalance to occur in negotiations that may influence the outcome of the audit engagement. This is of particular concern to regulatory authorities in implementing rotation policies that by necessity brings in fresh engagement partners into engagements with experienced CFO’s and finance directors.

2.3.9 Auditor transitions

A quintessential argument is: Does audit partner rotation weaken or strengthen an engagement partner position in auditor negotiations? Prior research identifies that audit failures are more likely to occur in the first few years of an engagement. It can be deduced from this that audit partner rotation leads to the engagement partner being at a disadvantage in client negotiations in the first few years of an engagement. Dodgson et al. (2020) describes

the context in which audit partner rotation regulations have been implemented in the US. The SOX establishes that audit partners and concurring partners must rotate every five years but does not establish any parameters for other party interactions. This gives an audit firm a great degree of latitude to manage and implement rotations as they see fit. Dodgson et al. (2020) provides qualitative research evidence of how audit firms plan for upcoming rotations. This process starts with assigning a relationship partner for complex entities and the identification of appropriate candidate to go through an interview process. Dodgson et al. (2020) states that some interviewee's mentioned that there is senior partner involvement at the executive level, and that audit firms have internal processes to ensure continuity, commitment, trust and the sharing of knowledge through the transitional process. The significance of Dodgson et al. 's research is that rotations are not a single discrete event but a carefully staged process that may or may not be the intention of regulatory authorities. Considering regulatory authorities have not looked to interject themselves further into the process implies an understanding of the complexities involved in rotating audit partners especially for larger complex entities. Dodgson et al.'s (2020) study provides qualitative research evidence that audit firms consume resources in the management of audit partner rotation regulations.

Dodgson et al.'s (2020) research states that the audit partner rotation process starts eighteen months to two years before the incoming audit partner takes over from the incumbent engagement partner and that audit partner rotation is not a stand-alone event. Pittman et al. (2022) found that audit firms are more likely to assign an incoming audit partner that has jointly conducted a prior engagement with the incumbent audit partner. Audit firms look to minimise the loss of client specific knowledge when transferring engagement partners (Dodgson et al. 2020). By assigning colleagues that have connections, the audit firm can improve the transference of client specific knowledge enabling the incoming engagement partner to hit the ground running and maintain client satisfaction levels. Pittman et al. (2022)

suggests that the incoming engagement partner is more likely to be chosen when they have shared more teamwork experience with the incumbent engagement partner and concludes that individuals with stronger connections are more likely to be appointed especially on more complex audits. Evidence from this research supports the finding made by Dodgson et al. (2020) that audit firms train the incoming engagement partner to prevent knowledge loss and ensure a smooth partner transition.

2.3.10 Large client entities

Corporations have been growing in size over the century with their revenue now exceeding the GDP of a number of small countries (Johnston et al. 2022). Large corporations can be trans-national with multiple subsidiaries and divisions. Auditing a large complex entity often involves a hierarchical group of auditors that have to aggregate financial information from multiple components to form the consolidated financial statements of an entity (Stewart and Kinney, 2013). The IESBA define another key audit partner as a person that audits a subsidiary or division in an entity. An other key audit partner that audits a subsidiary is easily distinguishable because of their remoteness and identifiable contributions in a corporations annual report. An other key audit partner that audits a division or department is not as easily identifiable because their contributions to the financial statement is not explicitly stated.

Section 290.164 (b) of PES 1 states that engagement partner following an engagement should not have contact with the client or provide advise to the engagement team.

Regulations do not appear to prohibit an audit partner being involved in the audit prior to becoming the engagement partner. Dodgson et al. (2020) provides qualitative research evidence that incoming engagement partners may shadow the incumbent audit partner, and that audit firms may train an incoming audit partner into the engagement partners' position. Auditing a large client entity involves multiple audit partners, regulations do not prohibit an

engagement partner being involved in the audit prior to becoming the engagement partner.

What this suggests is that audit firms when auditing a large client entity are able to have an audit partner present on the engagement prior to becoming the engagement partner. Which allows them to form relations and gain an understanding of the clients specific matters.

2.3.11 Managing audit partner rotation

New Zealand has implemented a multi-dimensional system of audit partner rotation for engagement partners, EQCR's, and other key audit partners for different entity types with corresponding cooling-off periods. Research done by Dodgson et al. (2020) and Pittman et al. (2022) have found that audit firms manage the rotation process to reduce the loss of client specific knowledge. Lennox et al. (2014) found that audit partner rotation results in increased effort from the exiting engagement partners and incoming audit partner. Sharma et al. (2017) states that transferring audit partners results in increased costs for the audit firm. The multi-dimensional system of audit partner rotation in New Zealand and research evidence indicates that audit firms need to construct a complex system for the management of audit partner rotation. New Zealand is currently experiencing an auditor shortage which is stressing the resources of audit firms.

Human resource management provides literature on how organisation can set up matrixes and rosters for the efficient allocation of their human resources and development of employee's skills (Baird and Meshoulam, 1988; Rogstadius et al. 2011). Audit firms in transitioning engagement partners are focused on not losing client specific knowledge and retaining institutional knowledge within the engagement. Human resource management involves a set of internal policies for a firm's human capital including collective knowledge, occupational specialisation, and knowledge-based intangibles such as the abilities of employees to understand the specific needs of a client (Baird and Meshoulam, 1988; Huselid et al. 1997; Schuler and Jackson, 1987; Quinn, 1992). The internal policies of human

resource management relate to the auditing principles of institutional knowledge, industry experience and client specific knowledge.

The basic structure of a matrix in human resource management is two dimensional. More complex matrix models can encompass three dimensions or more (Belout and Gauvreau, 2003) and can be seen as a necessity for managing large global organisations (Bartlett and Ghoshal, 1998; Galbraith, 1994; Kramer, 1994). New Zealand is experiencing an auditor shortage which requires audit firms to closely monitor the portfolios and capacity of licensed audit partners and be aware of the skills and experiences, so they have to fill the roles that are available (Lammintakanen et al. 2002). Effective human resource management includes the appropriate allocation of employees to specific tasks. Assigning workloads based on financial rewards can be detrimental to the employing organisation if the employee is likely to accept increased workloads even when the impact of these workloads may have a negative effect on the employee's well-being (Baird and Meshoulam, 1988; Rogstadius et al. 2011). Management in allocating workloads must consider if the acceptance of an increase workloads will result in poorer quality outputs (Toe, 2023).

2.3.12 Summary

To be critical of the literature in this review, most of the literature on audit partner rotation is quantitative with the exceptions of Dodgson et al. (2020) and Beattie et al. (2004) that provide qualitative studies. Quantitative research on audit partner rotation uses proxies as measures for audit quality (Bamber and Bamber, 2009) such as income increasing abnormal accruals, restatements, going concern opinions, and just meeting or missing earning benchmarks (Carey and Simnett, 2006; Chi & Huang, 2005; Chen et al. 2008; Myers et al. 2003). The problem with the approach of this research is that it treats audit partner rotation as a stand-alone event. Research by Dodgson et al. (2020) and Pittman et al. (2022) have discovered that audit partner rotation is not a stand-alone event but is potentially managed by

the audit firm. Which potentially explains why prior research on audit partner rotation has not been able to justify the costs that it has imposed on audit firms and consumers.

2.7 Gaps in the research

Mandatory audit partner rotation has remained controversial because neither regulators or researchers have provided evidence of increased benefits to justify the costs incurred to the audit profession and clients from its implementation (Bamber and Bamber, 2009; Sharma et al. 2017) which motivates more research into the subject. The central debate in research is on how longer or shorter engagement tenures affect audit quality. Researchers that argue against audit partner rotation do so stating that in the early years of an engagement partners tenure the financial statements are more likely to be misstated (Chi & Huang, 2005; Chen et al. 2008; Jenkins & Velury, 2008; Knechel & Vanstraelen, 2007; Myers et al, 2003). While proponents for audit partner rotation argue that long tenures result in a diminution of audit quality from the engagement partner being less likely to challenge opportunistic accounting decisions, and that the ‘fresh perspective’ of the incoming audit partner will result in increased efficiencies and audit quality (Carey & Simnet, 2006; Chi & Huang, 2005; Chi et al. 2009; Fitzgerald et al. 2018).

Audit partner rotation research has been mainly carried out in large-scale economies such as the US, China, Taiwan, Australia, South Korea. New Zealand has implemented audit partner rotation regulations similar to these larger countries. Comparatively these countries have significantly larger audit firms with increased audit partner resources. There has been very little research done on transposing regulations from large-scale economies to a small-scale economy. This research looks to fill this gap in research by interviewing audit partners to gain an in-depth understanding of how they perceive the implementation of regulations from larger-scale economies into the New Zealand audit market.

Researchers such as Dodgson et al. (2020) who studied audit partner transitions in the US, finding that audit firms assign ‘relationship managers’ and there is senior partner involvements in the transition process. Pittmen et al. (2022) who researched audit partner rotation in China, suggesting that audit firms train incoming audit partners into the engagement partners’ position. Lennox et al. (2014) who also investigates audit partner rotation in China, finding that audit partners work loads are increase in the early years of an engagement. And Sharma et al. (2017) that studied audit partner rotation in the US, providing evidence of increased fees around rotation. All indicate that audit firms manage the rotation process. To the researcher’s knowledge no research has been conducted into the management of audit partner rotation, consequently this research will interpret the experiences of audit partners to provide qualitative research evidence on how audit firms manage audit partner rotation.

Regulators negatively interpret the social psychology perspective that long relationships result in changes in attitudes and behaviours. Yet, social psychology also extolls the virtues of ‘trust’ in long relationships, associating ‘trust’ to enhance communication between organisational actors (Ellemers et al. 2002: Hogg and Terry, 2000: Riketta, 2005). Audit partner rotation periodically ends auditor-client relationships. The consequential issue is whether audit partners in longer or shorter relationships are more or less likely to confront management on opportunistic management decisions. How audit partner rotation impacts the auditor-client relationship in auditor negotiations has not been studied. The is research will investigate this issue by using qualitative research methods to discover this change to engagements partners reality.

Chapter 3: Methodology

3.1 Introduction

This chapter explains how the research was designed and carried out. The paradigms used in this research will be discussed as well as the epistemological approach. This section includes the methods, interview design, interview questions, sampling, data collections, data analysis, and ethical considerations.

The purpose of this study is to discover how audit partner perceive the imposition of mandatory audit partner rotation regulations and the implications. Identifying the correct research methods is critical for providing credibility to the findings (Graneheim and Lundman, 2004). What has been identified, is that most prior research in the area is mainly quantitative (archival) and comes from countries that have larger economies than New Zealand. Qualitative research is a process of enquiry that looks to uncover shared understandings based on methodological traditions that explore a social or human problem (Khan, 2014). Throughout history, auditing has been perceived to be a socially constructed phenomenon (Andon et al. 2015; Power, 2003). Bryman and Bell (2015) state that qualitative research's main focus is on words with the objective to increase contextual knowledge by exploring a social phenomenon.

What is being studied are the implications to audit partners and audit firms from a regulatory change, which impacts their social and institutional realities. Contextual constructionism objectively recognises that reality is constructed from multiple realities all of which are meaningful (Burningham and Cooper, 1999). Social constructionism assumes that no reality has precedence over another in claiming truth about a social phenomenon (Andrews, 2012). Epistemology provides for a clear link between the researcher and participant, by talking and listening to a participant in an autonomous setting a more personalised model of data collection can be established (Sanders et al. 2012). Taking an

epistemological approach this research will look to discover how the increased regulatory environment affects individuals' actors as well as the audit firm they belong to, looking to discover how they have dealt with it without judging a specific method to be the correct one.

Gray (2009) argues that deductive reasoning moves towards hypothesis testing to verify, while inductive reasoning seeks to discover binding principles to construct generalisations. This study will use themes and follow-up questions to portray generalised principles related to identifiable topics. The establishment of these identifiable topics will be used to evolve the research question (Braun and Clarke, 2006).

This research is looking to interpret the perspectives of audit partners to gain a greater understanding of the realities that they and their audit firms now face.

3.2 Interview design

The identified research problem is that New Zealand has transposed a multi-dimensional audit partner rotation structure from large countries. There does appear to be any literature on the implementation of audit partner rotation into a small-scale economy such as New Zealand which is why the researcher asks the first research question "how do audit partners perceive the imposition of mandatory audit partner rotation regulations? Using the qualitative method of semi-structured interviews will allow the researcher to gain an in-depth understanding of the phenomenon being studied +(Bryman and Bell, 2015).

By synthesising literature done by Dodgson et al. (2020), Pittman et al (2022), Sharma et al. (2017), and Lennox et al. (2014) which suggests that audit firms use significant resources in managing audit partner rotation, the researcher asks the second research question "what are the implications of mandatory audit partner rotation in New Zealand" to discover the changes in audit partners realities the paradigm of social constructionism is used to interpret the meanings of experiences (Andrews, 2012).

The interview design for this study is to use semi-structured interviews to gain the perspectives of audit partners centred around the research problem and explore the experiences of the participants.

Based on prior research twelve initial interview questions were constructed to ask audit partners, however, two interview questions were later discarded following the first interview based on discussions between the primary supervisor and the researcher. These two questions were determined to be repetitive, interrupting the flow of the interview. The interviews were then structured around ten open-ended questions to ask participants. The openness of the questions allowed the participants to fully express viewpoints and experiences, follow-up or probing questions were then asked based on interesting responses to pre-constructed questions (Turner, 2010).

The first six interviews were conducted by the primary supervisor and the researcher, following each interview the primary supervisor and researcher debriefed the interview discussing different points that each individual audit partner had made. From these identified topics were identified to be followed up on in subsequent interviews to gain generalisations from audit partners and to gain additional knowledge. Interviews were free flowing with interview questions not necessarily being asked in the same order. The interviewers asked probing questions to explore topics as they were discussed.

Due to geographic disbursement of interview candidates, eleven of the interviews were conducted via an online video conferencing facility 'Zoom' which allows the researcher to pre-schedule one-on-one or group face-to-face interviews and five of the interviews were conducted in person. Eleven of the interviews were carried out one-on-one and two interviews consisted of two participants. One-on-one interviews took on average 52.3 minutes and interviews that consisted of two audit partners took on average one hour thirty six minutes.

Conducting the interviews face-to-face and one-on-one, including those via 'Zoom' allowed the interviewer to paraphrase interview questions and establish a rapport with the interviewee, which encouraged an open expression of views by taking note of non-verbal cues from interviewees (Baxter and Jack, 2008). To avoid normative answers and a reluctance to provide sensitive information to the research question interviewees were assured of both confidentiality; and a verbatim transcript for them to review. They were also able to withdraw any information that they didn't want used in the study, of which three made alterations to the transcriptions and one withdrew several statements. Saunders et al. (2012) argued that a semi-structures approach is more desirable allowing participants to express more of their experiences.

Each interview consisted of ten open-ended research questions to be asked participants based on prior research. Follow-up questions were used to explore interesting topics and previous interview evidence that had been identified by the primary supervisor and researcher. This subsection will provide the reasoning behind asking the research question followed by the research question that was asked in the study.

The first question was constructed from Daugherty et al. (2012) study. This research was based on the perception that more stringent mandatory audit partner regulations could affect the quality of an auditor's quality of life and provided evidence that audit partner rotation increased the likelihood that audit partners would have to relocate. Not knowing how audit partner rotation may have affected New Zealand audit partners quality of life we ask the question:

1. Please describe your experiences of audit partner rotation(s)? What had happened?

Please describe this process.

The purpose of making audit partner rotation mandatory is to sever the relationship between an audit partner and a client. It can be presumed that audit firms generally want to retain their audit clients, which is why we asked the second question:

2. How did the above rotation(s) affect your relationships with clients?

By synthesising a number of research studies: Dodgson et al. (2020), Pittman et al. (2022), Sharma et al. (2017), and Lennox et al. (2014) the researcher identified that research should be done into how audit firms manage audit partner rotation. Which is why the researchers asks:

3. From your audit firm perspective what changes have you observed taking place following the introduction of audit partner rotation? What steps have management taken to ensure that audit quality and good client relationships have been maintained?

Rainsbury's (2019) research provides evidence that there has been a near 50% reduction in domestically registered audit firms. Which indicates that significant market concentration has occurred in the New Zealand audit market. The researcher looks to discover the route cause and implication to audit firms by asking:

4. From an industry perspective what changes have you observed taking place following the introduction of audit partner rotation? What steps have management taken to ensure that audit quality and good client relationships have been maintained?

Regulators in implementing audit partner rotation are presuming that it will increase audit quality from the auditor providing a 'fresh perspective' of the audit engagement (Carey and Simnett, 2006; Daugherty et al. (2012). Prompting the research question:

5. How do you evaluate whether audit partner rotation policies have achieved their objective(s)?

Question six could be described as a probing question. It was designed so that audit partners could relay any unintended consequences of audit partner rotation, that are currently unknown:

6. Are there any implications of mandatory audit partner rotation that you had not anticipated until you experienced the rotation yourself? Please describe.

DeFond and Lennox (2011) state that introduction of a regulatory agency significantly disadvantages small audit firms. To understand this phenomenon, the researcher asks:

7. The introduction of the FMA in New Zealand can be said to have reduced the number of domestically registered audit companies. How would you evaluate this statement? What do you think might be the reason?

Researchers of audit partner rotation use proxies for audit quality (Bamber and Bamber, 2009) without making any consequential findings. How audit partners perceive audit partner rotation affecting audit quality is relatively unknown, which is why research asks:

8. How do you relate audit partner rotation policies to audit quality you have described?

Many countries have implemented audit partner rotation policies in varying forms. New Zealand has aligned itself with the US, UK, Australia, and Canada. In contrast to this approach the European Union has mandated audit partner rotation at seven-years on followed by a two-year cooling off period. This motivates the research question:

9. Do you feel like audit partner rotation policies are suitable in their current form?
What recommendations would you make to regulatory bodies regarding there suitability and the appropriateness of timeframes?

Following a standard qualitative research design, the last question that is asked is:

10. Before we conclude this interview, is there anything else you would like to add?

3.3 Data collection and analysis

3.3.1 Populations and Sample

The regulatory situation in New Zealand is that domestic audit firms and auditors are registered through CAANZ and the FMA authorise the issuance of licenses to overseas auditors and audit firms. NZX, FMA and OAG's entities are the only entities that are subject to audit partner rotation regulations which must be carried out by a licensed audit partner and licensed quality control reviewer who belong to a registered audit firm. Consequently, the target population for this study are licensed audit partners who belong to a registered audit firm.

The New Zealand Companies Office maintains a register of all New Zealand licensed audit partners and registered firms which is supplied to them by CAANZ and the FMA. On the 1st of August 2022, a complete list of New Zealand licensed auditors was downloaded from the New Zealand Companies Office website. This sample included 143 Licensed audit partners from New Zealand, 28 licensed audit partners from Australia and one from Singapore.

The Auditors Register – New Zealand Companies Office provides the name of the licensed auditor, company which they work for, address of the company, employee status details (e.g., partner, director, employee) and email address. Each audit partner on the Auditors Register – New Zealand Companies Office was contacted by email and sent an introductory email that informed potential participants (that participation was voluntary and all information would be treated confidentially), a consent form, an information sheet describing the study, and a set of interview protocols.

The table below presents the results from emailing 172 audit partners from the Auditor Register at the Companies Office. Thirteen audit partners agreed to be interviewed, eleven of these interviews were conducted individually and one interview was carried out

with two participants. A referral resulted in another two licensed audit partners agreeing to be interviewed which was carried out simultaneously. This gave the researcher a total of thirteen completed interviews consisting of fifteen interviewees, a participation rate of 8.72% or 10.48% for audit partners that reside in New Zealand.

Table 4: *Interview Demographics*

Panel A: Locations of audit partners		
	Number of Partner Interviewees (n = 15)	Percentage of Partner Interviewees
Auckland	8	53.33
Christchurch	4	26.67
Wellington	2	13.33
Hastings	1	6.67
Panel B: Distribution between Big Four and non – Big Four		
	Number of Partner Interviewees (n = 15)	Percentage of Partner Interviewees
Big Four	7	46.67
Non – Big Four	8	5.33
Panel C: Industry expertise*		
	Number of Partner Interviewees (n = 15)	Percentage of Partner Interviewees
Financial Services	6	23.07
Insurance	4	15.38
Manufacturing	5	19.23
Government sector	4	15.38
Other (real estate, not-for-profit, Retirement villages, technology)	7	26.92
<u>*Some audit partners may have more than one area of expertise</u>		

The primary empirical data for this research project was obtained from conducting semi-structured interviews with New Zealand audit partners. Semi-structured interviews allow for flexibility in the interview approach and the possibility to obtain rich information and a deep understanding of the issues at hand (Bryman and Bell, 2015). Interviews were transcribed by the researcher and sent to participant for their approval. These finalised transcriptions provided the data for results and analysis.

3.3.2 Data Analysis

This research took a thematic analysis approach for processing the results of the raw data. Thematic analysis was used for its flexibility in processing raw data and approach to meaning generation from patterns within the data set (Braun and Clarke, 2017). Following each interview, the researcher and primary supervisor discussed the interesting topics that had been raised within the interview, the researcher then looked to expand on these topics with future participants. By using this method distinctive patterns evolved within the research with audit partners providing perspectives that could be generalised or contrasted within different categories. In many cases this represented a tangible-extension of knowledge on the identifiable topic with audit partners communicating different aspects on the topic unique to their own or audit firms' perspective.

Ten open-ended questions had been sent to participant in advance and it was conceived (though not confirmed) that the participants had prepared for the interview. The interview method meant that not all participants responded to the follow-up questions. Though not all interviewees directly responded to these questions interviewees had often referred to these topics in the conversations, which allowed the researcher to generate themes inside the topic areas discussed.

Thematic analysis has been used to analyse the data, the first step in analysing the data was to search the interviewee transcriptions to identify generalised topics of discussion, these generalised topics of discussion were put together in the excel sheet to form themes. The open-ended research questions were structured based on gaps in the literature and identified demographic problems. To answer the research questions, themes were put into buckets to form central topics that were present in the open-ended research questions that were asked in the interviews with audit partners. This process resulted in three central topics: Implications to the audit firm, planning and engagement mechanisms, and engagement partner client relationships.

Themes were developed by conceptualising ‘central organising concepts’ that came from the constructed open-ended questions and probing questions. Qualitative research can produce large amounts of data (Pope et al. 2000). Being an inductive exploratory study transcripts were read and then re-read for any identifiable themes and then coded diversely not taking into account themes that previous research had identified on the topic (Hollway, 1989). Codes were collated into central themes in systematic fashion across the entire data set to collect as much relevant data to each code. Following the constructionist paradigm, a latent approach is adopted. Themes and patterns were ‘mashed up’ together to gain a greater understanding on the conceptualised topic and a description of the stated reality (Braun and Clarke, 2006).

The analysis resulted in four identifiable categories amongst participating audit partners: Big Four, non-Big Four, managing partners, and new audit partners. The objective of identifying these was to perform additional analyses and present different perspectives within the dataset. This also allowed the researcher to make comparisons of how these different categories had dealt with the imposition of a mandatory audit partner rotation policy and present different viewpoints of the construction of a regulatory agency.

To gain a deeper understanding of the data, how participants phrased certain answers was analysed with the categories of positive, negative, moderate being assigned.

3.3.3 Ethical considerations

This research was approved by the University of Canterbury's Human Research Ethics Committee and considered to be low risk research. Though this research was considered to be low risk it was assessed that some questions or topics discussed may involve sensitive information. The introduction of specific regulations may have led to negative situations occurring in the interviewee's personal lives. Information was provided to the interviewees in the information sheet explaining not required to answer any questions that they consider sensitive in nature or make them feel uncomfortable in any way. Participants were also advised that participation was voluntary, and they had the right to withdraw from the research project at any stage, up until a six-week period following the interview and they had been given the opportunity to comment on the transcript where they were able to withdraw all or parts of their information.

To ensure the reliability and validity of the research data the aims, purpose, and interview process were well presented on first contact with the participants. Emails to potential participants contained an introduction to the research project, consent form, information sheet, and interview protocols. Participants were required to return the consent form before the interview took place and the information sheet contained information that advised the participant of the interview process. Should a participant have withdrawn their interview information the raw materials collected in the interview would have either been returned or destroyed.

To ensure confidentiality and anonymity codes were assigned to replace the names of the participants and firms (e.g., interviewee 1 of Company A). Furthermore, no locations or

identifying material will be revealed. To ensure the identity of participants wasn't known to anyone outside the research team, we will keep your signed consent form in a file separate from your interview transcript. All data will be destroyed after five years following the completion of the study.

Interviews were either recorded using a portable recorder or using the Zooms audio-recording feature. One interviewee did not initially consent to be recorded via the Zooms audio-recording feature, but then gave consent at the time of the interview after the interviewee explained that all information was to be kept confidentially and his identity would remain anonymous.

Chapter 4: Findings

4.1 Introduction

The purpose of this chapter is to present the results from the semi-structured interviews with New Zealand audit partners. The research question “how do audit partners perceive the imposition of mandatory audit partner rotation regulations?” will be answered by the responses of audit partners from the different categories and their perceptions of the imposed regulations. The second research question “What are the implications of mandatory audit partner rotation in New Zealand?” will be answered by providing qualitative research evidence that describes the consequences to audit partner and audit firms from regulators implementing rotation requirements.

Participant responses have been grouped together into threads of conversation to provide perspectives on prior literature and in some instances, new qualitative research evidence has been contributed. What the researcher envisioned was that each interviewee would add to the body of knowledge on a subject area. Interviewee responses have threaded together to form meaning around a subject area. This is way the interview evidence has been presented. Where more than one interviewee has been cited (Interviewee 1NonBig4, 2Big4, 3NonBig4, 4Big4) indicates that each of these audit partners have said something very similar or have confirmed a participant’s response.

4.2 Implications of audit partner rotation on audit practice in New Zealand

Before audit partner rotation was made mandatory, audit firms were required to mitigate the ‘familiarity threat’ and long association risk as part of their internal controls. This requirement in the ethical standards, while not mandating rotation created an understanding that over familiarity was a threat to independence. The UK’s Financial Reporting Council (FRC) provides statistical evidence that the number of registered audit firms worldwide have been reduced. Rainsbury (2019) states that there has nearly been a 50%

reduction in New Zealand domestically registered audit firms providing evidence of significant market concentration.

In New Zealand there approximately 500,000 small businesses, 10,000 medium sized businesses and 2,500 large businesses (Roberts, 2021). Making audit firm demographic environment one of mainly small to medium-sized entities with a few large client entities. New Zealand has transposed audit partner rotation regulations from large-scale developed economies. Regulators should consider ‘right-sizing’ regulations before they are implemented (Quack and Shubler, 2015). Rainsbury (2019) and Haughton et al. (2013) found that regulations disproportionality disadvantage small and medium-sized audit firms due to increased costs. DeFond and Lennox (2011) states that regulators are likely to target small audit firms in the first few years that they commence operations.

The section of the chapter will be set out as follows: Firstly, that audit firms were already rotating their audit partners. Secondly, audit partner rotation and market concentration. Thirdly, audit partner rotation effects both Big Four and Non-Big Four audit firms. Fourthly, the practicality of audit partner rotation regulations. Fifth, audit partner rotation puts pressure on an audit firms licensed audit partner resources. Sixth, large complex clients require significantly more audit partner resources.

4.2.1 Solidifying audit partner rotation policies

Making audit partner rotation mandatory is based on the notions that engagement partners in long relationships are less likely to challenge management on an aggressive financial position. Interview participants communicated that audit firms in New Zealand were already rotating their audit partners based on this notion: *“So, rotation as a concept is something that most firms had an internal policy on even if there wasn’t necessarily a hard and fast external policy”* (Interviewee 1, NonBig4). Audit regulations pre-audit partner rotation in New Zealand stated that audit firms must mitigate a long association risk. Audit

partners confirmed that this was being implemented: “*We have a policy of reviewing rotation after 7 to 10 years*” (Interviewee 11, NonBig4) and they perceived long tenure to be of concern “*familiarity over ten years we say you can't do it*” (Interviewee 2, Big4). Interviewee 9, NonBig4 provided the perspective that: “*There are a few people out there that operate the same client for twenty years, so I think that is a bad thing*”. Participants provided the perspective that the implementation of audit partner rotation regulations was a solidification of the regulations, and the regulatory environment was just catching up with what was happening in the industry. Participants in this study, shared the same values as regulators perceiving that long tenure is a threat to independence.

4.2.2 Audit partner rotation and market concentration

Prior research by Rainsbury (2019) associated the reduction of domestically registered audit firms in New Zealand to the implementation of a regulatory regime. Participants in the research resonated such views: “*What you're seeing these days is that there are [sic] less and less firms doing audits...it's quite hard for small firms and they have started just saying no to doing audits*” (Interviewee 4, Big4). “*The FMA said at the start we're not going to force the small players out. They've just made the rules such that people decide to, because it's too difficult to comply*” (Interviewee 9, NonBig4). “*For firms like us, if they keep making the rules harder, it may get to the point that firms in the mid-tier start to drop out. I think certainly the firms that have dropped off so far have probably been the smaller ones*” (Interviewee 10, NonBig4) and it is audit partner rotation that is impacting market concentration “*So, what they're doing is limiting the licensing market to the Big Four....you're talking five or six firms that can probably manage the rotation easily, for the rest it's challenging*” (Interviewee 11, NonBig4). “*There's been a significant decrease in the volume of small firms doing audits*” (Interviewee 10, NonBig4). Non-Big Four audit partners comments were critical of the effect that audit partner rotation had on small audit firms. Audit

partner rotation can also be considered a tool for the regulatory regime to use, to increase market concentration in a small-scale economies.

Haughton et al. (2013), Rainsbury (2019) state that the implementation of a regulatory regime disadvantages small audit firms: *“I think certainly the firms that have dropped off so far have probably been the smaller ones that maybe on hindsight, decide they didn't want to be part of the regime, and you can well understand that, because it's very onerous”* (Interviewee 10, NonBig4) *“there's a couple of people that we know, that have withdrawn from being licensed..... both of them in fact, are mid-tier. If they're not top 10, the top 12 firms globally that are represented in New Zealand”* (Interviewee 11, NonBig4). The consequences for some entities that need to be audited are: *“They are going around town almost saying, will anyone do my audit and all the Big Four are going ‘no’ we won't”* (Interviewee 5, Big4) *“We have turned clients away”* (Interviewee 10, NonBig4). The entities that appear to be getting mostly effected are: *“We have turned down some very small, not for profits”* (Interviewee 11, NonBig4) *“it's very uneconomical for us to audit a lot of charities”* (Interviewee 4, Big4). What can be interpreted from the comments made by participants is that regulators regime has had unintended impacts on the supply of audit services in New Zealand. Entities that are legally required to be audited should have access to auditors at a reasonable price and have their audit completed within a reasonable time frame.

4.2.3 Audit partner rotation effects both Big Four and Non-Big Four audit firms

Prior research identifies that the inception of a regulatory regime significantly impacts smaller to mid-sized audit firms. Participants from non-Big Four audit firms put forward the critical perspective: *“From a practice management point of view it has been difficult for the mid, smaller sized firms simply because you don't have that many partners in each geographic location”* (Interviewee 1, NonBig4). *“We can make it work, it's not ideal, if you were a small firm, you've just got to give up jobs”* (Interviewee 6, NonBig4). *“Life would be*

simpler without this” (Interviewee 9, NonBig4). Non–Big Four audit partners were in negative agreement that audit partner rotation adversely affected them. These comments also indicated that audit partner rotation was causing small audit firms to leave the domestically registered audit market.

Participants from Big Four audit firms confirmed that audit partner rotation was disproportionately affecting small audit firms: *“It would be more challenging for a small firm with fewer licensed auditors”* (Interviewee 2, Big4). *“Maybe in smaller firms it's quite difficult, when you've only got one or two partners”* (Interviewee 4, Big4). Managing partners from Big Four audit firms provided the perspective that it: *“Is making sure that you've got a sufficient partner resource to be able to rotate on and off appropriately, and to have the right skill sets, to deliver high quality audits”* (Interviewee 5, Big4) stressing the importance that *“being able to have enough sufficiently qualified and experienced people to do the various roles within the context of partner rotation”* (Interviewee 2, Big4). The context of Big Four audit partners was one of providing the right audit partner based on experience and industry knowledge, which could be contrasted against the views of non-Big Four audit partners whose concern was having sufficient partner resources to provide their clients with an audit partner and EQCR.

4.2.4 The practicality of audit partner rotation policies in New Zealand

Audit partners questioned whether audit partner rotation regulations were practical in the New Zealand setting, conveying that: *“New Zealand is a small economy that has small scale commercial firms..... and smaller scale audit firms and practices”* (Interviewee 1, NonBig4). Interviewee 10, NonBig4 provided the perspective that audit partner rotation is likely to work well for audit firms with significant partner resources but caused problem for audit firms with limited partner resources. Interviewee 1, NonBig4, made the generalised comment regarding implemented regulations: *“Some of the stuff they are trying to implement*

here, which really has an international focus and frankly is impractical to do in New Zealand commercially” *“because it’s just hard to see the relevance”* (Interviewee 3, NonBig4).

Participants critically evaluate the implementation of audit partner rotation regulations because of the international focus of regulations and audit firm size. What these comments express is that regulators in implementing audit partner rotations regulations need to consider the demographic variables of a country, such as GDP and population size.

Participants perceived that New Zealand follows overseas when implementing regulations: *“The bigger thing I’m struggling with in New Zealand, we are standard takers not makers”* (Interviewee 6, NonBig4). *“New Zealand does tend to follow overseas. I think being a follower in this stuff is quite good because we’re smaller anyway”* (Interviewee 9, NonBig4). *“One thing else I’ve noticed over the past ten years plus.....whenever a new standard comes out, we want to adopt it, we don’t want to be dragging the chain or being seen as a second-class citizen”* (Interviewee 10, NonBig4). The question is whether the regulations are suitable for the New Zealand audit market: *“Those people that are driving it are sitting in very large firms from large countries and the application in New Zealand is quite different and quite difficult”* (Interviewee 11, NonBig4). *“An international standard comes in and we talk to our clients, but we have to adopt it, yet sometimes it doesn’t quite fit New Zealand”* (Interviewee 6, NonBig4). Audit partners were not in agreement *“I believe that New Zealand should be a standard taker.....we should just take international standards and double-check to make sure it applies to New Zealand”* (Interviewee 9, NonBig4) because *“you can kind of observe what’s happening overseas”* (Interviewee 4, Big4) contrasted against: *“Both in accounting standards and auditing standards we are far too fast to implement things that are international, that are written for large scale international markets and corporates and are really not applicable”* (Interviewee 1, NonBig4). Some participants perceived that the New Zealand regulators were implementing regulations without

considering whether they are practical in the New Zealand setting. While other participants perceived that there were advantages from adopting regulations from overseas.

4.2.5 Audit partner rotation puts pressure on the audit firm to increased their licensed audit partner resources

Audit partners communicated how the management of audit partner rotation was directly related to the amount licensed audit partners that an audit firm has and that audit partner rotation significantly impacted audit firms with only a small number of licensed audit partners: *“The reasons that we merged was that we actually saw the regulations, rotations and FMA coming into play as being a need to really have more partners, because of the rotation issues”* (Interviewee 11, NonBig4) *“two things have tended to happen, one is there has either been some mergers or moving around of the firms, or they have loosely joined together to contract each other in”* (Interviewee 1, NonBig4). Interviewee 9, NonBig4 potentially expressed this best, stating: *“For auditor regulations our belief is that without four licensed auditors you can't comply. So, we have four licensed auditors and I want to bring in a fifth”*. This point of view was reiterated by Interviewee 6, NonBig4: *“Because to have auditor rotation you would need to have at least four audit partners in a firm, because.... it's not just the lead audit partner, it's the quality control audit partner that has to rotate as well”*. The consequence for audit firms with less than four audit partners was that: *“You get one of the small firms saying, I'll be the quality control partner on yours and you can be the quality control partner on mine”* (Interviewee 6, NonBig4) also expressed by *“I am aware that some of those firms use partners from another firms to be the EQCR for example on their jobs”* (Interviewee 1, NonBig4). Interviewee 6, NonBig4 then made the critical observation: *“Where does the liability land if things go wrong”* highlighting potential litigation problems in the event of an audit failure. The requirements for becoming a licensed audit partners is 3000 hours auditing work, 750 of those hours has to be spent auditing FMC

or NZX entities creating difficulties for non-Big Four audit that have limited NZX and FMC clients (Interviewee 11, NonBig4).

4.2.6 There are significantly more resources involved in auditing large complex entities

New Zealand can be described as having mainly small and mid-sized entities with a few large commercial entities. Participants discuss the amount of audit partner resources required for different sized entities: *“Most audits would have one partner, maybe with a EQCR as well”* (Interviewee 4, Big4) *“in New Zealand you'd have a signing partner.....and the quality control partner”* (Interviewee 5, Big4). Participants from Big Four audit firms explain how larger more complex clients involve significantly more audit partner resources: *“You have one signing partner, and then you have about six to seven partners supporting them”* (Interviewee 4, Big4). A significant issue for Big Four audit firms was that audit partner rotation reduced their ability to provide the most suitable engagement partner with industry experience: *“It's quite a small pool of partners that can actually do some of these jobs”* (Interviewee 12, Big4) *“we'd have probably four partners in New Zealand to be honest, with sufficient maturity and experience to be able to be put up for that panel”* (Interviewee 2, Big4). *“I doubt there is more than ten of us that are truly experienced in auditing a bank or maybe it's fifteen”* (Interviewee 5, Big4). What can be interpreted from participant responses is that small and mid-sized entities only require an engagement partner and EQCR. Larger more complex clients involve multiple partners, significant to audit partner rotation is that New Zealand has a very small pool of auditors that can audit large complex clients.

Auditing large complex multinational entities involves group aggregating information from different audit teams across different industries (Stewart and Kinney, 2015). Group auditing research provides example of auditors drawing on specialists within the industry (Trotman et al. (2015)). Participants provided qualitative research evidence that large complex clients involve several audit partners, with specialist skill sets: *“I normally have a tax*

specialist, a treasury specialist, we call the financial risk management specialist, an accounting specialist for some of our complex accounting standards, and we might have a corporate finance specialist” (Interviewee 8, Big4). *“When you think of specialists, partner inputs, some of these audits will have tax technology professionals, valuation specialists”* (Interviewee 5, Big4). Bank audits are configured: *“Let’s use the bank for example, we would typically have the lead partner/signing partner, we might have a second audit partner as well, who would probably have responsibility for treasury, we would then have a valuations partner, so they would value all the derivatives, then also but not always a partner..... loan provisioning and then depending on if they’ve got insurance.....an IT partner..... we don’t have tax partners the same way”* (Interviewee 12, Big4) and large complex audits have a second partner: *“Who was the second partner on the job”* (Interviewee 5, Big4,). *“We’ve got a lead partner who signs, we’ve got a second partner who’s involved in quite a lot of details”* (Interviewee 2, Big4). Participants from generally Big Four audit firms provide a structure for auditing large complex clients consisting of an engagement partner, an audit partner second in charge and other audit partners that head specialist areas within the engagement.

Managing partners perceive: *“We have problems or difficulties in terms of coordinating audit partner rotation just with the number of different roles that we have, and then also the different roles in an engagement”* (Interviewee 2, Big4) *“because you’ve got multiple partners in there, you’d never design your model as a firm where you had all of them starting at the same time, all leaving at the same time”* (Interviewee 5, Big4). The purpose of which: *“So that a lot more institutional knowledge is present in the year that the partner comes on”* (Interviewee 5, Big4) because *“if they all have to rotate roughly around the same time, you have a little bit of institutional knowledge loss”* (Interviewee 7Big4). What the audit firm is trying to achieve is: *“They will have brought through a more junior partner who can be the continuity”* (Interviewee 8, Big4, 5). Interviewee 5, Big4 explains how: *“You might be*

losing partner A as your signing partner, but actually, there's every chance one of the other partners you've known for the last three years might be coming into that signing partner role, or if a new pattern is coming in, you've still got partner B or partner C, who was the second partner on the job anyway” and *“You don't want your EQCR and your lead partner rotating off at the same time”* (Interviewee 8, Big4). large entity audits can be considered to be: *“They are complex beasts”* (Interviewee 7, Big4) *“if you think about it logically on a big job, it takes you longer to get to grips with it”* (Interviewee 8, Big4). To summarise, audit firms have multiple audit partners involved in auditing a large complex clients that rotate on and off at different stages, so that the audit firms retain institutional knowledge in the engagement, providing an example of how audit firms manage their human resources (Rogstadius et al. 2011)

4.3 Planning and coordination mechanisms

Through the last section of this research, participants provided qualitative research evidence that audit partner rotation disproportionately affects small and mid-sized audit firms because of limited licensed partner resources. At the other end of the spectrum Big Four audit firms have difficulty providing audit partners for all of the roles they have available. Both Big Four and non-Big Four audit firms focus on providing audit partners with industry experience and retaining institutional knowledge within the engagement. What participants have communicated is that audit firms have to carefully manage audit partner rotation so that audit quality is not affected.

This sections of the chapter will be set out as follows: Firstly, audit partner rotation involves a complex matrix. Secondly, transitioning audit partners is complex. Thirdly, an engagement partners capacity and portfolio. Fourthly, rotating the EQCR challenges an audit firms’ resources. Fifth, engagement partners and client specific knowledge. Sixth, the audit

team drives audit quality. Seventh, the more complex the entity the more time on an engagement partner needs.

4.3.1 Audit partner rotation involves a complex matrix

What was identified early on in this study was that audit firms have implemented varying forms of matrixes or logs to manage audit partner rotation: *“It’s actually quite a complex matrix to get it to work, so there’s actually more complexity than I think the audit regulators probably envisaged”* (Interviewee 1, NonBig4). *“I think it’s a complex matrix.... even in a large firm like ours it is complex”* (Interviewee 12, Big4). *“We have created a log to monitor movements of rotating partners”* (Interviewee 3, NonBig4). The complexity of the matrix comes from: *“Managing the myriad of different rules”* (Interview 7, Big4). *“It’s added a layer of complexity for the firm to manage.... if it’s a public listed company, a five-year plan, if it’s an OAG audit a six-year plan, and for an FMC audit a seven-year plan”* (Interview 8, Big4). Audit firms also have to manage rotation for the EQCR (Interviewee 1, NonBig4) *“and other key audit partners on the engagement”* (Interviewee 7, Big4). That audit firms use a matrix to manage audit partner rotation is new to research and a key finding of this study.

Big Four audit partners describe how they use: *“A global rotation database”* (Interviewee 7Big4). *“We also run a global rotation process”* (Interviewee 5, Big4) that can capture *“ten years for your signing partners, your engagement quality review partner, any other key audit partners involved in the engagement, and also increasingly the managers on the engagement”* (Interviewee 7, Big4) and it is a *“reasonably sophisticated systems where we’re planning our rotations, two or three years out”* (Interviewee 5, Big4). Consistently, both Big Four and non-Big Four audit partners talk about planning for future rotations: *“We are looking two to three years out”* (Interviewee 2, Big4). *“What is forecast to happen in the next three or four years”* (Interviewee 3, NonBig4). *“We will plan out the next five or seven*

years” (Interviewee 6, NonBig4,) then *“every three months it gets reviewed and approved”* (Interviewee 5, Big4). because partners rotate off and retire (Interviewee 7, Big4). Audit partners from Big Four audit firms discuss the: *“Difficulties in terms of coordinating audit partner rotation just with the number of different roles and different engagement types”* (Interviewee 2, Big4) and *“even though we are one of the bigger firms, it's still a finite group”* (Interviewee 4, Big4). The findings from this section identify that audit firms use a complex matrix to manage the multi-dimensional structure of rotation in New Zealand. Consistently, both Big Four and non-Big Four audit partners talk about planning rotations years in advance, and regularly updating the matrix. Where these two groups differed: Big Four audit partner discuss a global rotation system, while some non-Big Four audit partner refer to the matrix as a log, indicating that Big Four audit firms have a three-dimensional matrix while non-Big Four audit firms are likely to just have two (Bartlett and Ghoshal, 1998; Galbraith, 1994; Kramer, 1994).

4.3.2 Transitioning the engagement partners involves a number of complexities for the audit firm

Research done by Dodgson et al. (2020) investigated how audit firms transition engagement partners from client to client in the US, finding that audit firms use a relationship manager and that other senior audit partners are involved in the transition process. Participants stated that audit firms were involved in transitions of audit partners. Findings suggest that there were distinctive differences between how Big Four and non-Big Four audit firms managed the process and that transitioning audit partners was incorporated into the matrix of audit partner rotation.

The process for non-Big Four audit firms started with: *“The new partner sitting down with the existing partner or senior manager, who is most familiar with a client and works through what's involved”* (Interviewee 3, NonBig4). The process involves talking about

differences and questioning the treatment off balances: *“I’d definitely be talking to the other guy and saying why did you do it that way, have I missed something”* (Interviewee 6, NonBig4). Non–Big Four audit partners also thought it was: *“Getting the matrix right so you’ve always got some consistency of the skills”* (Interviewee 1, NonBig4) stressing the importance of having either the engagement partner, EQCR, or audit manager having industry experience *“we try and keep the engagement manager and team.... on the job.... that helps with institutional knowledge”* (Interviewee 11, NonBig4). Interviewee 11, NonBig4 describes how the incoming partner will attend the: *“Planning meeting, go to the concluding meeting, and meet the board.... then rotate onto the engagement the following year”*. The above interview data shows that there is a transfer of knowledge between the partners and that they prioritise retaining experience and institutional knowledge within the engagement. By transitioning the engagement partner audit firms are minimising the loss of client specific knowledge and threats to audit quality (Dodgson et al. 2020; Pittman et al. 2022).

Participants from Big Four audit firms describe a more formalised approach to transitioning engagement partners. Managing Partners select candidates for upcoming engagements based on the audit partner: *“Having the right industry experience”* (Interviewee 5, Big4) *“availability, background and experience”* (Interviewee 2, Big4) stressing that *“it’s important for us that we manage the transition well in terms of both client expectations and timing”* (Interviewee 2, Big4) having *“a conversation with management and the audit committee chair around the types of skill sets that they have found valuable”* (Interviewee 5, Big4) *“giving them a panel to look at for example”* (Interviewee 2, Big4). Clients: *“Understand the importance of having a relationship that they can work with”* (Interviewee 2, Big4) *“the incumbent partner would be involved in that process to the extent that they have a good feel for the type of personality, and the chemistry that’s going to be needed for a particular client”* (Interviewee 5, Big4). This studies concurs with Dodgson et al. (2020)

research that audit firms provide clients with a selection of audit partners to choose from and that senior partners are involved in the traditional process. What participants are repetitively emphasising is the replacement partner must have industry experience and be able to have a relationship with the client (Abbott and Parker, 2000).

A significant finding from this study is that audit firms match the personality type of the engagement partner to the client. Interviewee 4, Big4 explains: *“You get to meet them, just to make sure they're a good fit, because of different personalities, we're putting the right personalities with the right clients. Because what you want is tension, but not too much tension”* and having a relationship is important for completing the audit: *“We can understand that the audit partner needs to be a cultural fit and it's important that you have a relationship, otherwise you can't do the audit”* (Interviewee 7, Big4). The engagement partner must also have the industry experience and be able to constrain a client's aggressive financial position: *“I've seen situations where a partner comes off rotation, ideally suited technically, but also ideally suited personality wise to a client that pushes the envelope, and that client needs a strong partner... we've rotated them off, and the option is a partner that perhaps is less well-suited”* (Interviewee 8, Big4) *“we do a lot of internal work here and we call it business chemistry”* (Interviewee 4, Big4). Big Four audit partners through this sections describe some of the complexities to the engagement partner client relationship. The engagement partners must have a relationship with the client to transfer information and complete the audit, have the technical knowledge or industry experience, and be able to constrain a client's aggressive financial position. Emphasising the importance of matching personalities and a matrix for audit partner rotation.

The audit partner then meets with the client: *“Clients like to consider who will come on and meet with them as an audit committee chair, just to make sure they're comfortable, that works well”* (Interviewee 2, Big4) *“then the firms would typically share candidates with them*

to either meet” (Interviewee 5, Big4) *“it could be as simple as bringing them along to a meeting”* (Interviewee 4, Big4). Though critically: *“I am reluctant to get too much into a beauty parade, here are three you can pick from. I'm not saying we don't do that, because sometimes there is a need”* (Interviewee 7, Big4). Big Four audit firms start the process: *“We would be planning our rotations twelve to eighteen months out”* (Interviewee 7Big4) *“we would typically start that process, twelve to twenty-four months ahead”* (Interviewee 12, Big4). Participants in this study echo Dodgson et al. (2020) research that transitions start eighteen months to two years out.

Once it's established who the new partner will be on the engagement, that partner will then be involved in shadowing the incumbent partner to get familiar with each other (Interviewee 12, Big4). *“What we would like to do is involve them in a couple of shadow meetings, they won't charge any time and won't make any decisions, to make sure that the transition works”* (Interviewee 7, Big4) so that they become aware of the issues and to *“start building those relationships”* (Interviewee 12, Big4) *“it makes sense that both the transition partner and the current partner are involved in the judgments”* (Interviewee 13, Big4). *“It gives the partner a chance to come to clearance meetings and have a little bit of an overlap, so you can do an efficient hand over”* (Interviewee 8, Big4). What's important: *“Is when we manage the process of transition is to ensure that when we go from one partner to another partner, we are not losing knowledge, the really fundamental knowledge of the issues”* (Interviewee 5, Big4). Interviewee 4, Big4 provides the perspective that: *“Often the exiting partner is still around, it's not like knowledge is lost, but you do actually put up those walls as well with the previous partner because you're a new partner coming in”*. The purpose of the transition process is so that the new partner: *“Is ready to pick it up straight away, so they are not starting cold”* (Interviewee 12, Big4). Audit firms in managing the transitional process are assuring the client that knowledge is not being lost, that the incoming audit

partner will have already established relationships and have understanding of the judgments being made. The purpose of this is so that the incoming audit partner will hit the ground running when they become the engagement partner (Pittman et al. 2022).

4.3.3 Audit firms need to consider an engagement partners capacity and portfolio

In constructing a matrix to manage audit partner rotation the audit firm must consider an audit partners portfolios: *“As you start to broaden it out, you are starting to look at the manageability of total portfolios for audit partners”* (Interviewee 1, NonBig4) which is determined by *“the capacity to come on to that job, how does that fit with their other portfolios”* (Interviewee 12, Big4) because it’s all about timing and the portfolio’s we have (Interviewee 3, NonBig4). What has to be considered is: *“How many clients can an audit partner realistically have or should have”* (Interviewee 1, NonBig4). Big Four audit partners communicated that an audit partners portfolio is managed by a: *“Risk and quality team”* (Interviewee 2, Big4) to ensure *“we don't go over our five years or seven years”* (Interviewee 12, Big4). Managing partners are involved in the allocation of engagement partners to clients: *“We make a recommendation, we'll look at people's portfolios, availability, background and experience, and make that assessment”* (Interviewee 5, Big4). *“One of the things you've got to do is actually find out what experience you've got”* (Interviewee 6, NonBig4) and that they *“haven't got any conflicts”* (Interviewee 12, Big4). To accommodate a significant client, auditors may be required to: *“Go through processes where you might rotate early....to free up capacity”* (Interviewee 13, Big4) with the planning starting *“five years out”* (Interviewee 12, Big4) to ensure that the partner has the right experience to go onto an engagement. A consequence of audit partner rotation and the auditor shortage is that audit firms need to closely manage and audit partner portfolio capacity to ensure that the partners work life balance is maintained (Lammintakanen et al. 2002).

4.3.4 Rotating the engagement quality control reviewers challenges an audit firms resources

Audit regulations stipulate that the audit partners, engagement quality control reviewers (EQCR), and other key audit partners are subject to rotation regulations adding additional complexity to the matrix. Audit partners discuss the impacts of rotating the EQCR: *“I think it’s made managing the business hard, because what you need to think about is, are the audit partner and EQCR going to have to roll off in two years’ time”* (Interviewee 8, Big4). *“The other thing is timing if your quality review partner and the engagement partner have to rotate at the same time, that’s challenging.... and the other really problematic thing is on your really large audits, is you also have other key audit partners”* (Interviewee 7, Big4) increasing the complexity of the rotation matrix. Audit firms also need to consider client competitors when replacing audit partners, Interviewee 8, Big4 explains how a client will not appreciate an audit partner being moved onto a direct competitor following rotation.

Little research has been done on the involvement of the EQCR in the audit engagement. Interview participants discuss the role of the EQCR: Interviewee 1, NonBig4 stated that in the engagement process the EQCR should have no contact with the client, which was then confirmed by: *“The other partner is what we call an EQCR who isn’t client facing”* (Interviewee 12, Big4) and what regulators need to consider is *“the risk with them becoming too close to the crime doesn’t exist”* (Interviewee 5, Big4) relating the EQCR to becoming over familiar. Audit partners perceived that having an EQCR was one of the tools to address familiarity: *“The aspect of familiarity is addressed in different ways, part of that is having the EQCR”* (Interviewee 13, Big4) because the purpose of the EQCR is to: *“Challenge the engagement team and ensure quality”* (Interviewee 12, Big4). Managing partners provided the perspective that: *“It’s important that you have another perspective, we have that to a certain extent with the EQCR”* (Interviewee 2, Big4). *“Having a slightly longer*

period and more familiarity with the entity and more history with the issues that have arisen is probably going to enhance your audit quality” (Interviewee 5, Big4). Participants in this study provide qualitative research evident that the EQCR has no contact with clients and that the EQCR’s purpose is to challenge the engagement partner and team. Participants describe the EQCR’s position as being independent and that there is no threat of the EQCR becoming familiar with the client.

Audit partners didn’t see the usefulness of long cooling–off periods for EQCR’s: *“You can’t flip from being an engagement partner to an EQCR and I think that’s a shame”* (Interviewee 9, NonBig4). *“Intuitively to me it feels like I could probably do a great job of being an EQCR, so I’m not sure why I would need two more years off”* (Interviewee 5, Big4) *“I think you need two years minimum, you could have three for the partner and two for the EQCR”* (Interviewee 11, NonBig4). Interviewee 13, Big4 explains that some of the supply issues with audit partners comes from their capacity to be an EQCR on client engagements which limits their ability to be the engagement partner. Participants viewed the cooling–off periods for EQCR’s critically which potentially comes from regulators not providing a justification for why EQCR’s need to cool–off. The complexities of the rotation requirements for EQCR’s is likely to be contributing to the auditor shortage in New Zealand.

4.3.5 Audit partners with client’s specific knowledge increase audit quality

Researchers that argue against audit partner rotation do so on the basis that by rotating the audit partner you lose client specific knowledge (Myers et al. (2003): Several interview participants provided the perspective that industry experience improved the judgements that audit partners made an improved audit quality through knowledge of the client operations (Interviewee 7, Big4). The argument as stated by Interviewee 6, NonBig4: *“You might go, there so specialized maybe he’s become complacent”* then expanded on *“the risk is, you get complacent and not challenge things enough”* (Interviewee 11, NonBig4). New Zealand audit

partners agree that industry knowledge does improve an engagement partners decision making, but also perceive a risk in longer engagements of becoming complacent.

Interviewee 11, NonBig4 provides the perspective that: *“The biggest risk is that you lose a lot of institutional knowledge when you rotate the engagement team”* and that *“a lot of institutional knowledge is kept within the audit firm”*. That there is a lot of knowledge within the audit team is confirmed by: *“You retain all of that collateral knowledge within your manager and audit seniors within the firm”* (Interviewee 4, Big4) *“we make sure there is continuity of the audit manager or senior staff on the audit”* (Interviewee 1, NonBig4) and that rotation *“puts more responsibility on the manager.....it's really because of that base knowledge, that understanding is often with the manager”* (Interviewee 4, Big4). What can be identified from these comments is that changing the engagement partner is less of a risk than changing the audit team, though: *“You do have some risks when you rotate partners”* (Interviewee 11, NonBig4) *“because you’ve been forced to rotate to someone that has to learn the whole industry”* (Interviewee 1, NonBig4).

The size of New Zealand’s audit market is a factor that influences industry specialization: *“New Zealand [SIC] too small to have specialists in industries”* (Interviewee 6, NonBig4). The identifiable problem with rotation is: *“Because we're so small you can lose specialization”* (Interviewee 6, NonBig4) *“you’ve lost your industry specialisation because you’ve been forced to rotate”* (Interviewee 1, NonBig4) *“were losing industry specialization, which is critical to audit and that's really, really important....very specialized businesses may be a challenge for audit partner rotation because is that new partner really adding value or reducing value to the audit function”* (Interviewee 6, NonBig4) because *“you can't just go and pull in a random partner and say you're now a (industry 1) specialist, when they’ve never done that”* (Interviewee 12, NonBig4). New Zealand audit partners were in agreement that engagement partners with industry specialist knowledge outperform engagement partners

without industry experience confirming research by (Knechel et al. 2013; Messier et al. 2008).

4.3.6 The audit team drives audit quality in an engagement

Carcello et al. 1992 categorised audit team and audit firm experience, client knowledge and industry expertise as one of the four most important factors for determining audit quality. New Zealand audit partners provided their perspectives on how the audit team impacts audit quality: *“The team of people together is what gets that audit to the result”* (Interviewee 8, Big4). *“If you’ve got a good director a good team....combined with a good [sic] client management, you are a long way on the road to a good quality audit”* (Interviewee 12, Big4). Because: *“The practical reality is the works being done at a manager and team level”* (Interviewee 1, NonBig4). Then linking the audit team to audit partner rotation: *“That partner rotation period is quite a good time to refresh the team to make sure that we're still being current”* (Interviewee 2, Big4). *“By rotating the partner, you've still got a lot of the previous knowledge retained within other team members, which is really important”* (Interviewee 4, Big4). The quality of the people within the team is important: *“That meaningful work ethic is huge..... all our people should be high quality delivering the best”* (Interviewee 13, Big4). *“The way we frame it with our clients, is we expect them to be looking at the quality of service, the audit quality, the challenge that we provide as an audit team to your management team”* (Interviewee 2, Big4) *“the incremental difference, is having really good quality people and good quality teams”* (Interviewee 1, NonBig4) because *“it's a joint thing between a whole lot of people”* (Interviewee 8, Big4) *“they're working out, what's the opinion? have we complied”* (Interviewee 2, Big4). Interview participants were in agreement that the audit team is one the biggest determinant of audit quality and that the fundamental knowledge held within the audit team is really important for the audit firms to maintain audit quality.

4.3.7 The more complex the business, the more time on an audit partner needs

Audit firms and engagements partners need to control for entity size and complexity in an audit. Larger more complex entities can have increased numbers of transactions, divisions and multiple subsidiaries adding layers of complexity to the audit engagement and increasing the likelihood that the financial statements could be misstated, as the engagement partner becomes more remote from the transactional data being produced. Audit partners discuss the impact of complexity on the audit: *“It's always been a debate, what's the appropriate time for rotation, and I don't know what the answer to that is, it really depends on the complexity”* (Interviewee 4, Big4). *“I think if you look at an audit, it's an incredibly complex thing... on a big job that is very complex, it takes you a lot longer, to make sure you do it well”* (Interviewee 8, Big4). *“FMC reporting entities are not simple, they've usually got some areas of complexity in them, and so it does often take you some years to really get a thorough understanding of how they work and how issues have been responded to”* (Interviewee 10, NonBig4). Participants agreed that size and complexity are significant factors for determining when engagement partners should be rotated, though critically, new audit partners make the observations: *“When you think about why it's there, it's the familiarity risk, so that doesn't change depending on complexity”* (Interviewee 13, Big4) *“I think it depends on the complexity of the client, how many partners are involved”* (Interviewee 4, Big4).

Audit partners questioned cooling-off periods: *“It's probably on the cool off stand down part of it which is a bit onerous in the New Zealand setting”* (Interviewee 1, NonBig4, 6NonBig4) *“I don't think you need to be off for five years.....personally I think if you have no involvement at all, two years is fine”* (Interviewee 8, Big4) and that the cooling-off periods present the biggest challenge to the audit firms: *“I think probably the cool down periods probably are the biggest challenge for us in the local market given our size, five years off is a*

long time” (Interviewee 12, Big4). Critically raising the question: “*Why five years versus two years.... does that five years actually benefit anybody*” (Interviewee 13, Big4). Participants also provided perspectives on cooling-off periods for the EQCR: “*The EQCR is three, I'm not really sure why the EQCR is three and not two years like the other key audit partners, because I think two years gives you an appropriate time to refresh, but also gives you the advantage of coming back with some knowledge*” (Interviewee 7, Big4).

Participants in this study were critical of cooling-off periods for engagement partners and EQCR's suggesting that they were too long and could be reduced to two-years for both the EQCR and the engagement partner. Participants also communicated that New Zealand regulators were determining the length of cooling-off periods to align our regulations with international standards. The implications of the managing partners comments (Interviewee 6, NonBig4) are that increased rotation policies and extended cooling-off periods are levers for increased market concentration, which implies that reducing these levers will decrease market concentration. Evidence from prior research found marginal improvements in audit quality from extending the cooling-off period.

4.4 Relationships between engagement partners and their clients

That last sections of this chapter discovered that audit firms match personalities between the engagement partners and clients. Participants in this research provided qualitative research evidence that auditor client relationships include gaining information to complete the audit and gain an understanding of the entity, technical abilities or industry experience to maintain audit quality, and an engagement partner must be able to constrain management taking an aggressive financial position. Audit partner rotation periodically ends these relationships, which potentially effects audit quality in the first years of the engagement (Carey and Simnett, 2006).

This section of the chapter will be set out as follows: Firstly, the early years of an engagement partners tenure. Secondly, the incoming audit partners ‘fresh perspective’. Thirdly, audit partner rotation enhances the new partners ability to challenge management. Fourthly, audit partner rotation reduces the ‘familiarity threat’. Fifth, management perceive audit partner rotation as an inconvenience. Sixth, boards of directors’ view audit partner rotation as good governance. Seventh, organisational employees are constantly changes.

4.4.1 The first years of an audit partner’s engagement

Researchers argue that in the first few years of an audit partner’s engagement the financial statements are more likely to be misstated while an audit partner builds up knowledge and experience. Audit partners confirm that the engagement partner in the first few years on an engagement is on a learning curve: *“You’ve got your first year when you’re learning the client”* (Interviewee 2, Big4) *“in your first year you might ask a lot of stupid questions because you’re on a learning curve”* (Interviewee 4, Big4) *“you have your first year of getting up to speed, building relationships”* (Interviewee 7, Big4). *“What I find is that in year one on an audit you learn all the big picture stuff”* (Interviewee 9, NonBig4) *“the most dangerous year... it’s always a big learning experience”* (Interviewee 10, NonBig4). *“You’re only really understanding and hitting your straps by year two”* (Interviewee 12, Big4) the *“first year is always a bit lumpy”* (Interviewee 3, NonBig4). Audit managers provided the perspective that, an engagement partner will not be as familiar with an organisations affordable risk in the first year of an engagement which reduces audit quality (Interviewee 5, Big4) *“firstly, you challenge them, and you get some response, and you accept it”* (Interviewee 2, Big4). These statements from audit partners confirm the research perspective that the financial statements are more likely to be misstated in the first year of an audit partners engagement while they build up knowledge and experience.

Interviewee 5 Big4 suggested that: *“Your second year is when you think your starting to get on top of things”* *“I do an audit, in the second year I pick up on things I didn't pick up in the first year”* (Interviewee 6, NonBig4) *“year two you're filling in gaps.....you're finding out stuff which you didn't realize you got wrong in year one”* (Interviewee 9, NonBig4) *“I don't know how you can get a grasp of a company within a year or two, and then you get a year or two of actual quality”* (Interviewee 4, Big4). To manage this, managing partners encourage in-depth discussion between the exiting partner and incoming partner before they pick up the audit, so that they are aware of what to challenge management on (Interviewee 5, Big4). Interviewee 2, Big4 states how in the second year you confront management and tell them that their key assumptions aren't working. What's important is that: *“By rotating the partner, you've still got a lot of the previous knowledge retained with another team members, which is really important”* (Interviewee 4, Big4) *“it's helpful having a manager that's got a relationship with them”* (Interviewee 11, NonBig4) *“there is continuity of the audit manager and senior staff on the audit, so the actual audit work is being done by people who have some continuity and experience”* (Interviewee 1, NonBig4). Collectively audit partners perceive that: *“you typically tend to find as you work through your second year, or maybe even your third, that you learn more and more”* (Interviewee 10NonBig4). What can be concluded from this is that engagement partners rely heavily on their audit managers in the first year and look to rectify any mistakes that may have been made in the second year of an engagement.

Interestingly Interviewee 5, Big4 describes how: *“One year in five, the audit is not as good as the other four potentially, then you could easily say, with a five-year rotation, that in the last year how interested is the partner going to be? Are they going to be focused on their next rotation, or are they going to be focused on their last audit? So, if you took a really negative view of it, you'd argue that two of the five years, forty percent are not at the optimal level”* Interviewee 5, Big4's critical analyses of audit partner rotation relates directly to

research evidence that states that audit quality is not as high in the first year of an engagement, and confirms Winn (2021) research that provides evidence of audit partners not being focused on an audit in the year before rotation.

4.4.2 The engagement partners ‘fresh perspective’ can lead to increased audit quality

Regulators believe that the incoming audit partners ‘fresh perspective’ or ‘fresh set of eyes’ will improve audit quality, which was confirmed by interview data of this research:

“The new pair of eyes, the new experience, the different expectations the slightly different approach, that’s how you hope to see some quality, potentially some quality improvements” (Interviewee 1, NonBig4). *“There is no doubt there is some benefit [SIC] of having fresh eyes in there”* (Interviewee 8, Big4). *“My own personal experience has always been positive around having a fresh perspective on things”* (Interviewee 13, Big4). Audit partners are in agreement that audit partner rotation brings a ‘fresh perspective’ to the engagement which can lead to positive outcomes, affirming the regulatory regimes position.

Participants explain the ‘fresh perspective’ starts with: *“I’ve unapologetically said to the management of the entity, I’m new in here and I’m going to ask some questions on things”* (Interviewee 8, Big4) *“there’s always more questions asked and different aspects that come out of the audit”* (Interviewee 11, NonBig4). Leading to: *“It does create the opportunity to have a fresh look at some of those key judgments”* (Interviewee 12, Big4). *“Potentially you could get a new partner or new firm coming in saying, actually, I don’t think that treatment was correct, or they’re asking questions to try and understand it”* (Interviewee 4, Big4) *“someone coming in, doing it fresh might think well I had a client that had this sort of transaction a couple of years ago, and they counter for it this way, is this client doing it right or not”* (Interviewee 3, NonBig4). Interviewee 10, NonBig4 explains: *“You look at the balance and think that’s fine, we already dealt with that last year.....you don’t necessarily question it again, whereas bringing another partner on after a period of time means they will*

look at it with a fresh set of eyes, and they will question it again.....you get to challenge things that have been done in the past". Which: *"Takes people out of their comfort zones, I think that has definitely worked, if that was the objective of it"* (Interviewee 7, Big4). This research confirms prior research done by Daugherty et al. (2012) that audit partner rotation is a re-examination of the key risks and Lennox et al. (2014) that engagement partners peer review, each other's work. Then adds to this body of knowledge by providing details of how engagement partners critically re-examining treatments, judgments and balances through posing questions to the client, which makes audit partners rotation a process for the continual re-examinations of risks that may threaten the entity.

A key construct of the 'fresh perspective' is that it enhances the challenge to management: *"Five years of challenging a client? I think it's appropriate that you have someone new come in to continue the challenge or to continue the focus. So, the new partner comes in, and doesn't know the track record, the discussions, the detail"* (Interviewee 2, Big4) *"you're definitely asking all those questions about, why do we do it this way, I understand what the risks are, so you definitely are challenging"* (Interviewee 12, Big4). Interviewee 9, NonBig4 summarises how the engagement partner applies the 'fresh perspective': *"It's back to that whole fresh pair of eyes, risk assessment, audit focus, then is there a proper review of controls..... a different firm may have a different approach, so it's very complex"*. Audit partners agreed that the 'fresh perspective' and audit partners rotation increases the ability of the engagement partner to bring a fresh challenge to the management of an entity (Interviewee 6, NonBig4).

4.4.3 Audit partner rotation enhances an engagement partners ability to challenge

Beattie et al. (2004) provides research evidence that auditor-client negotiations often lead to adjustments being made in the financial statements. What can be concluded from this is that the auditor has challenged management on a specific treatment, judgment, or balance,

which has resulted in an adjustment being made. Audit partners explain that: *“Your job is to challenge people, so you are naturally going to be in debates, some debates you’re going to win and some you’re going to lose that’s the job of the audit partner is to change positions”* (Interviewee 6, NonBig4) *“I guess it’s how you assess and challenge the key assumptions”* (Interviewee 7, Big4). The point is to: *“If we find an issue, I explain to the client why we’ve raised the issue, you say this is what the rules say, this is what we’re doing, this is the problem that we have”* (Interviewee 10, NonBig4). Then linked to audit partner rotation: *“I guess the point of audit [SIC] rotation, as an auditor our role is really to hold the management of the company to account and challenge a lot of the assumptions that they’ve made in the financial statements”* (Interviewee 4, Big4) and *“audit quality comes down to being courageous, having courageous conversations with clients, and challenging them, and being able to demonstrate and to continue to challenge them in difficult circumstances”* (Interviewee 2, Big4). This research confirms that auditor negotiations can lead to the adjustments being made in the financial statements through the audit partner challenging management on the key assumptions that have been made.

A critical part of audit partner rotation is that the incoming engagement partner: *“You’re not just blindly coming on going, because partner 4 did it that way, it must be the right way, going back to individual partner risk”* (Interviewee 12, Big4) and bringing *“it is also the element of new different experiences and challenges, and dealing with different clients and different audit teams as well through that process”* (Interviewee 13, Big4). The incoming engagement partner needs to ask the question: *“Why do we apply this materiality benchmark? Why are these the risks”* (Interviewee 12, Big4). *“Have we really addressed the right risks? Have we set the right materiality?”* (Interviewee 13, Big4) with the purpose being to: *“Challenge our own previous judgments, not necessarily to result in a significant change, but to just reevaluate and confirm what those judgement were”* (Interviewee 12,

Big4). Interviewee 7, Big4 explains how the peer review process can lead to internal challenges with the audit firms, and that it can takes confidence to come to another view that the previous engagement partner. Because *“you’re always going to have judgment calls when producing financial statements”* (Interviewee 6, NonBig4). Audit partner rotation initiates: *“Getting to challenge things that have been done in the past and see if you agree with them or not”* (Interviewee 10, NonBig4) and *“you’re going to go straight in and challenge, because you kind of know that’s what your role is”* (Interviewee 6, NonBig4). Engagement partners in negotiations have to: *“Make judgments as they go, a lot of that is about looking someone in the whites of their eyes and just challenging them, asking them hard probing questions”* (Interviewee 4, Big4) and *“clients should be thinking of tendering or rotating when they don’t believe they can be sufficiently challenged and having robust conversations with their auditors, that’s ultimately what it is providing you don’t lose that knowledge”* (Interviewee 2, Big4). This research provides evidence that audit partner rotation is a critical reassessment of the material risks that the entity faces and that audit partners rotation initiates engagements partners challenging each other’s judgements resulting in sharing of knowledge and increased audit quality.

4.4.4 Audit partner rotation reduces the familiarity threat

Mautz and Sharaf (1961) were the first to suggest that a corrosive element could emerge in longer tenures. Regulatory agencies would develop the construct of a ‘familiarity threat’ based on the perception that engagement partner in longer tenures is less likely to challenge management on aggressive financial positions. Audit partners provide the perspective that: *“I think there is a familiarity threat that comes along if you’re just on the job for years and years”* (Interviewee 1, NonBig4). *“If I was being honest, there were a few clients I was getting a little familiar with”* (Interviewee 6, NonBig4). *“Familiarity over ten years we say you can’t do it. So, we’ve introduced the principles based on familiarity and*

independence” (Interviewee 5, Big4). “*When you think about why it's there, it's the familiarity risk*” (Interviewee 13, Big4). “*I think the intention of rotation is to ensure quality through removing familiarity and that's a really important thing*” (Interviewee 6, NonBig4).

Audit partners were in agreement that familiarity can be a corrosive element in an engagement, supporting the position taken by regulators in implementing audit partner rotation. Interviewee 13, Big4 states that: “*The objective of partner rotation is to meet the ethical requirements to reduce the familiarity threat*”.

Participants also associated overfamiliarity with potentially missing something in the financial transactions: “*You do find that you get familiar with your clients, so whether that means you miss things I don't know*” (Interviewee 3NonBig4). “*The partner overlooked that because he was perhaps too familiar*” (Interviewee 8Big4). Perceiving that familiarity may inhibit an engagement partner’s ability to challenge management: “*The risk is that you aren't asking those challenging questions*” (Interviewee 4Big4). However, familiarity can also be positive: “*You do get quite familiar with them which actually gives you an insight into audit risk and some of the fraud risk*” (Interviewee 1NonBig4). Interviewee 1, NonBig4 explains that as you accumulate audit knowledge of a client, the history behind transactions, you have increased knowledge of the risks that threaten the entity “*There's always also a risk.... that possibly they're not as familiar, and therefore they may miss something*” (Interviewee 11NonBig4). Participants argued the critical view that familiarity lessens the likelihood that engagement partners will challenge management on aggressive financial positions supporting research by (Chia-ah & Karlson, 2010) but they also support the view that there is a risk to audit quality in the first few years of an engagement that an audit partner may miss things from not being as familiar (Chi & Huang, 2005; Chen et al. 2008; Jenkins & Velury, 2008; Knechel & Vanstraelen, 2007; Myers et al, 2003).

4.4.5 Clients perceive audit partner rotation as an inconvenience

Proponents of audit partner rotation make the argument that by changing audit partners the incoming audit partner will be critical of managements taking opportunistic accounting decisions. The participants in this research perceived that audit partner rotation can frustrate management: *“They have to explain the same things all over again, which really frustrates clients”* (Interviewee 4, Big4) *“some clients see it as just another inconvenience, because doing an audit it is an inconvenience, and we go in there and when you have new people, they do ask silly questions”* (Interviewee 8, Big4) *“I think in general though there is quite a bit of resistance”* (Interviewee 9, NonBig4) *“I think from a management perspective, it's probably seen as more of a negative because there obviously used to dealing with the same people, and they have that relationship”* (Interviewee 11, NonBig4). Interviewee 6, NonBig4 explains why: *“I finally teach you about my business and you can't do my audit anymore and now I've got to get someone else in that doesn't know my business and I've got to teach them”* *“What we see is that even if a company or management is getting bad audit service, there's a perception that there's too much work, they'll create more work for themselves by changing audit firms”* (Interviewee 9, NonBig4). Prior research focuses on a perception that in longer engagements, audit partners may become sympathetic to management opportunistic decisions, this study finds no evidence to support that. But does provide evidence that the reason management are resistant to changing engagement partners is because it represents increased work volumes from having to teach auditors that don't understand their business. However, these perspectives are potentially influenced by the audit partner lacking knowledge about the client in the early years of the engagement.

Several participants perceived that consistency was important to the management of the entity: *“From a client perspective, they like having consistency”* (Interviewee 2, Big4). *“As the audit partner rotates, hopefully the team below remains reasonably consistent”*

(Interviewee 5, Big4), which can be considered a quality issue from the audit firms' perspective. *"We always try to have the consistency of either having the engagement partner, quality reviewer or the audit manager.....so you've always got some consistency of the skills"* (Interviewee 1, NonBig4) because *"those are the people that they want to see every day, and they're the ones that understand how it works"* (Interviewee 3, NonBig4). These participant perspectives confirm the audit quality aspect of having an audit partner and team that have client specific knowledge.

4.4.6 Boards of directors' view audit partner rotation as good governance

Dependent on the type of entity, either the audit committee or board of directors are responsible for appointing the audit firm. Part of this responsibility is to ensure that the auditors are independent and remain objective in the engagement. Participants suggest that directors viewed audit partner rotation as good governance: *"A lot of them like to apply best practice"* (Interviewee 4, Big4) *"So they didn't need to rotate, but they wanted to"* (Interviewee 10, NonBig4) *"it's seen as a good thing to do, its good hygiene, it's a positive"* (Interviewee 11, NonBig4) *"I think from the directors perspective on rotation it is very good for them, and it helps them from the governance perspective"* (Interviewee 13, Big4). Because it brings a 'fresh perspective': *"It was the board that said we would like a fresh set of eyes"* (Interviewee 10, NonBig4). *"I asked questions which perhaps hadn't been focused on before at the board level that was refreshing for them, it was a different discussion of different points"* (Interviewee 9, NonBig4). Interviewee 13, Big4 provided the perspective that directors were pushing for quality by ensuring that management provided paperwork regarding judgments and taking responsibility for the independence of auditors, because it's important that *"you've got an audit partner that will be able to challenge your management, and work through issues with them"* (Interviewee 13, Big4). Participants in this research

agreed that boards of directors' view audit partner rotation as providing assurance that they are gaining a 'fresh perspective' on the key judgment that have been made.

4.4.7 Organisational employees are constantly changing

According to the US Bureau of Statistics the average length of time an employee stays within an organisation is five-years (Sturt, 2015). What can be deduced from this, is that the audit partner will often remain with an entity for a similar amount of time as the employee, making audit partner rotation policies based on close client relationships superfluous. Audit partners perceive that: *"Most of these types of entities have had the same level of turnover that we would have had. Some of them would have twenty-five to thirty percent turnover in their finance team in the last two years, so it's a real challenge for everyone"* (Interviewee 2, Big4). *"I think probably from the people that we're working on, when I was there, they will be gone anyway, they will have completely changed their staff, so it'll be like a new relationship anyway"* (Interviewee 3, NonBig4) Interviewee 6, NonBig4 stated that on an entity he was auditing, the CFO had change and had a completely different board of directors, but would have still been to familiar because of the audit partner rotation regulations. *"In this case the clients had dramatic change within that period"* (Interviewee 9, NonBig4). *"I think the other thing that we've observed is that there's a lot of change at clients as well, you would very rarely have the same CEO, CFO for the whole rotation period, anyway"* (Interviewee 12, Big4) because *"where in a generation, where people staying in a job for more than five years doesn't happen much these days because the younger generation want variety"* (Interviewee 6NonBig4). Which leads to: *"In New Zealand there's so much changes happening at the organizations that we audit, you've already got a natural control there around the familiarity risk"* (Interviewee 13, Big4) reducing consistency *"it's not like you've got the same management team, same board, same audit team, it's very unusual to have that consistency through, even a five-year period"* (Interviewee 12, Big4). Bringing into question the cooling-

off period: “*Does that five years actually benefit anybody*” (Interviewee 13, Big4). Audit partner rotation regulations are implemented to reduce familiarity between the engagement partner and client. Since or during their inception, a generational change has occurred resulting in employees spending less time with an organisation, which brings into question the relevance of rotation.

4.5 Chapter summary

This chapter presented the qualitative findings on the three central topic. What was discussed by participant in implications of audit partner rotation on audit practice in New Zealand was that audit partner rotation requires and audit firm to have increased audit partner resources to manage imposed regulations. Planning and coordination mechanisms identified how audit could potentially manage audit partner rotation. Relationships between engagement partners and their clients provided qualitative research evidence on the affects of audit partner rotation in the early years on an engagement, and how the fresh perspective can improve audit quality.

The next chapter will discuss the key findings of this study and relate literature to the findings that have been made in this chapter, while identifying gaps for future research.

Chapter 5: Discussions

5.1 Introduction

The chapter discusses the empirical findings from the interviews with New Zealand audit partners. The method used in this research was thematic analysis. Following this method semantic analysis was used in the findings to interpret the significance of patterns into broader meanings and implications (Braun and Clarke, 2006). This chapter will move to the latent level to conceptualize the underlying ideas and ideologies, presenting the data three dimensionally to identify the features that gave the data particular form and meaning.

The discussions section of the chapter will be separated into three sections: Firstly, the implication of audit partner rotation on audit partner rotation. Secondly, planning and coordination mechanism. Thirdly, engagement partner client relationships.

5.2 Implications of audit partner rotation on audit practice in New Zealand

The findings section of this researched discovered that audit firms were already using their own internal controls to manage the ‘familiarity threat’. By making audit partner rotation mandatory regulators have increased market concentration and centralised audit services to larger audit firms with increased partner resources, the implications of this have been that small audit firms have either been forced to merge or leave the domestically registered audit market.

This section of the chapter will discuss: Firstly, that New Zealand audit firms were already rotating their audit partners. Secondly, how audit partner rotation has increased market concentration. Thirdly, the practicalities of audit partner rotation regulations in the New Zealand. Fourthly, audit partner rotation and non-Big Four audit firms. Fifth, audit partner rotation in large client entities will be described. Sixth, audit partner rotation and Big Four audit firms, the last section will present the conclusions.

5.2.1 Audit firms in New Zealand were already rotating their audit partners before audit partner rotation became mandatory

Before audit partner rotation was made mandatory in New Zealand audit firms were meant to use their own internal controls to mitigate a long association risk between the engagement partner and client. The New Zealand audit industry has been described as being largely unregulated until the FMA was establishment in 2011 (Rainsbury, 2019). The implementation of a regulatory regime and a three-dimensional system for audit partner rotation can be considered a regulatory intervention into the New Zealand audit market. Audit partners confirmed that audit firms in New Zealand were already rotating their audit partners generally between seven to ten years and that by making audit partner rotation mandatory was a solidification of the rules rather than the implementation of new regulations (Interviewee 1, NonBig4, 2, Big4, 9, NonBig4, 11, NonBig4). Audit partners perceived that by implementing audit partner rotation, the regulatory regime in New Zealand was catching up to the values of leading audit firms that identify long tenures as a threat to independence and over familiarity in the engagement as a problem (Interviewee 6, NonBig4).

Audit firms are naturally geographically disbursed to facilitate the needs of remote industries. New Zealand has a lot of small towns often centred around one large industry. The problem for audit firms in small towns is that they have only one or two audit partners servicing one large client. The perception of audit partners from larger audit firms is that these small audit firms lack the knowledge or the resources to apply International Financial Reporting Standards (IFRS) to an acceptable standard (Interviewee 6, NonBig4, 14, NonBig4). The problem from a regulatory perspective is that small audit firms are financially incentivised to keep major clients. Audit partners perceived that some audit partners were operating clients on a continual basis due to a lack of enforceable regulations (Interviewee 2, Big4, 9, NonBig4) negatively impacting the audit industry.

5.2.2 Mandatory audit partner rotation has resulted in increased market concentration in New Zealand

Rainsbury (2019) found that the introduction of a regulatory regime disproportionately affects small audit firms. This research agrees with Rainsbury (2019) but found that the predominant reason for the reduction in domestically registered audit firms was mandatory audit partner rotation. The imposition of audit partner rotation regulations significantly affected small and mid-tier audit firms in New Zealand based on a simple dynamic. Mandatory audit partner rotation regulations require small and mid-tier audit firms to have increase audit partner and EQCR resources to service their clients through time-on periods and extended cooling-off periods. This has significant implications for audit firms with limited partner resources. Participants from a number of different firms perceived that audit firms requires a minimum of four licensed audit partners to manage audit partner rotation with additional partner resources being required from other geographic locations. Audit firms that foresaw the effects of audit partner rotation merged or made arrangements with other firms to contract audit partners in, otherwise the audit firm had to opt out of auditing NZX, FMC, and OAG entities.

Four participants confirmed that audit firms with less than four audit partners were contracting in either engagement partners or EQCR's from other firms (Interviewee 1, NonBig4, 6, NonBig4, 9, NonBig4, 11, NonBig4). What these participants stated was that small audit firms were entering into mutual arrangements with other small audit firms for the supply of audit partners and EQCR's. Audit firms swapping and changing audit partners appears to be an unintended consequence of audit partner rotation.

5.2.3 The practical implications of audit partner rotation regulations in the New Zealand environment

Audit partners perceived that rotation regulations have caused some audit firms to leave the registered audit firm market and caused other audit firms to contract in licensed audit partners. This brings into question the practicality audit partner rotation settings in New Zealand. Audit partners from non-Big four audit firms were critical of audit partner rotation regulations based on the size and scale of commercial entities and audit firms. Interviewee 10, NonBig4 provided the perspective: “We are a very small country, with a very small number of auditors, whilst partner rotation might work great in a US firm which has one hundred and fifty audit partners. It doesn't necessarily work well in smaller firms in New Zealand”. Confirming the problem identified by the researcher and reiterating that to manage audit partner rotation effectively is dependent on the number of audit partners in the audit firm.

Audit partners in this research perceived that New Zealand was now a standard taker rather than a standard maker. It is very quick to adopt regulations from larger capital markets from around the world (Interviewee 1, NonBig4, 5, Big4, 6, NonBig4, 9, NonBig4). By doing so New Zealand is aligning the quality of auditing standards to international standards, the controversial topic then becomes whether audit firms in New Zealand have the partner resources to implement these standards without adversely affecting audit quality. Adopting a regulatory intervention from overseas may lead to a number of benefits to New Zealand businesses such as attracting foreign investment and conversely making it easier for New Zealand companies to operate in other countries. However, some participants perceived that this approach from regulators was not consistent with the size of New Zealand’s audit firms and commercial entities, because they were designed for large scale international markets and corporations making their application difficult to fit.

5.2.4 Audit partner rotation and non-Big Four audit firms

The participants in this study were made up of eight audit partners from non-Big Four audit firms and seven audit partners from Big Four audit firms. All the audit partners in this study came from audit firms that had at least four audit partners. This limited the perspectives to audit partners from audit firms that could effectively manage audit partner rotation though two partners involved were from companies that had been forced to merge due to audit partner rotation. It was clear that the current rules around rotation were both challenging to both of these identifiable categories. So far, the discussion has been focused on the most affected group of small audit firms. Naturally the discussion now moves to non-Big Four audit firms with at least four audit partners.

The table below presents the how audit partner resources are distributed amongst New Zealand audit firms. Big Four audit firms have between sixteen to forty-six licensed audit partners including audit partners that are located in Australia. Non-Big Four participant in this study came from audit firms from between four to thirteen licensed audit partners. The overarching difference between non-Big Four audit firms and Big Four audit firms in dealing with audit partner rotation was that Big Four audit firms have sufficient partners to resources to supply audit partners to all their clients, thus Big Four audit firms focus on matching the engagement partners to their clients based on industry experience and the specific roles within the engagement. Whilst non-Big Four audit firms focus on consistency of experience through the engagement team ensuring that either the engagement partner, EQCR, or audit manager has the appropriate industry experience.

Table 5: *New Zealand domestically registered audit firms and audit partner distribution*

Audit Firm	NZ audit partners	Australian audit partners	Total
PWC	32	14	46
Deloitte	22	7	26
Ernst & Young	14	2	16
KPMG	24	0	24
BDO	10	3	13
Grant Thornton	5	0	5
Baker Tilly Staples Rodway	10	0	10
William Buck Audit (NZ) Limited	4	0	4
RSM Hayes Audit	5	0	5
Silks Audit Chartered Accountants Limited	4	0	4
Crowe NZ Audit Partnership	4	0	4
KS Black & Co	0	2	2
PKF Goldsmith Fox Audit Limited	2	0	2
LNP Audit and Assurance PTY LTD	2	0	2
MNSA	1	0	1
Crowe Horewarth	2	0	2
Triple Ledger Limited	1	0	1
IRCS	1	0	1
AD Danieli Audit Pty Limited	0	1	1
Totals	143	29	172
Note 1: PWC has one licensed audit partner in Singapore, this person was counted into audit partners from Australia.			
Note 2: The data for this table was taken from the Licensed Auditors Register at the New Zealand's Companies Office on the 1 st of August 2022.			

EQCR's and engagement partners rotating at the same was considered a problem by participants which was initially caused by the way the regulations were brought in. The predicament that audit firms faced, was that within a relatively short period of time both the

engagement partner and EQCR would be ineligible to be on the engagement. Bringing the problem back to audit partner resources in New Zealand and that implementing audit partner rotation policies forces an audit firms to change audit partners and EQCR's. The consequence of this to client audits was the potential loss of institutional knowledge for a particular client and or industry. Audit partners from both Big Four and non-Big Four audit firms have included both the engagement partner and EQCR into the rotation matrix.

Research identifies that audit partner rotation is a problem for specialist audit partners in specialist industries, requiring partners to specialise in multiple industries (Hammersley, 2006). New Zealand like most countries have several niche industries in different geographical locations (Pells, 2022). The consequence for non-Big Four audit firms was that the imposition of audit partner rotation regulations may have resulted in audit firms rotating audit partners with specialist skills off their specialist client industries and replacing them with an engagement partners that does not have such knowledge, thus potentially lowering audit quality (Interviewee 1, NonBig4, 6, NonBig4).

5.2.5 Large client entities and audit partner rotation

To understand the significance of transposing audit partner rotation regulations from large-scale economies to a small-scale economy the researcher investigated large client entities. Client entity size in the US, UK, Canada, and Australia can be considered to be a lot larger than in New Zealand as are their audit firms. Large client entities generally contain different departments and multiple business units (Hammer, 2001: Kaplan and Norton, 2005). The designation of a other key audit partner is that they audit a subsidiary or division within an entity IESBA (2007). Big Four audit partners discussed auditing large complex clients both in New Zealand and overseas, providing evidence that large entity audits consist of between many more audit partners than the engagement partner and EQCR.

Dodgson et al. (2020) states that audit standards in the US merely state that the maximum number of years an engagement partner is allowed to stay on an engagement, followed by the length of the cooling-off period. In the New Zealand context, rotation policies set out by the XRB state that engagement partner following rotation should have no contact with the client following rotation (XRB, 2022). This leaves the door open in larger client audits for the second audit partner or an audit partner from a division to become the signing partner when the engagement partner is rotated. Interviewee 5, Big4 explains that in large client audits they stagger the rotation of audit partners to conserve institutional knowledge within the engagement and that the second partner or partner from a division that has already been involved in the audit may move into the engagement partners role. Big Four audit firms are effectively managing audit partner rotation to retain institutional knowledge in the engagement. The controversial issue is what was this the intention of the regulators in implementing audit partner rotation policies. The regulatory position is that the incoming partner will bring a 'fresh perspective' to the engagement. Big Four audit firms in bringing through a partner from either being the second partner or partner in charge of a division may have influenced that partners perspective of the engagement through an induction process (Pittman et al. 2022). This research provides evidence that an engagement partner may have been in the audit for two or three years prior to becoming the engagement partner (Interviewee 5, Big 4). While this gives the audit partner time to learn the entities client specific matters, it also gives the incumbent partner time to influence the partners perspective towards how the judgements of accounting standards have been determined which inhibits the 'fresh perspective' that they may bring to the engagement.

Regulators should assess a countries demographics before implementing regulations. Regulators in large economies conceive larger client entities and large audit firms. They then design regulations to meet those demographic conditions. In the context of audit partner

rotation, regulators should consider (1) whether the audit firms in a country have sufficient audit partner resources to be able to service their clients whilst allowing for time-on periods and cooling-off periods; and (2) whether the regulations could affect audit quality. By considering these demographic variables, the regulators would be ‘right sizing’ the regulations to fit the environment that they are being applied to (Quack and Schubler, 2015). That small audit firms have left the domestically registered audit market due to audit partner resource limitations brings into question whether the New Zealand regulators have ‘right sized’ the regulations to meet the demographics of the economy. Regulators can argue that matching your trading partners auditing regulations can increase trade between countries. Many countries have adopted audit partner rotation regulations since the corporate collapse of Enron and the passing of the Sarbanes Oxley Act 2002.

5.2.6 Audit partner rotation and Big Four audit firms

Audit partner rotation relies on there being a sufficient supply of audit partners with the appropriate level of experience and industry knowledge. From the audit partners perspective, they require an interchangeable supply of clients. Big Four audit partners perceived that there may not be comparable entities for an audit partners to take on after they have been rotated off from a high-profile client. Interviewee 12, Big4 discussed how audit partners may have to replace one large client with ten smaller ones. The effect of this on the audit partner is that they may lose specialized skills (Interviewee 6, NonBig4). Auditing and accounting standards are constantly being implemented and updated. Audit partner rotation in a country like New Zealand can cause audit partners to be forced out of auditing the industry that they are specialized in. The consequence of this is that audit partners may re-enter the industry with deteriorated expertise.

Audit firm and audit partner specialisation increases earnings quality (Arthur et al. 2017; Balsam et al. 2003). The concept of auditor specialisation is that as an audit partner

spends more time in an industry, they gain more industry experience and specialist knowledge. Big Four audit partners perceived that there were very few audit partners in New Zealand with the industry experience to audit certain entities, especially large complex entities. Industry experience gives the engagement partner an advantage in determining the correct treatments of accounting standards (Garcia-Blandon and Argiles, 2017; Carcello and Nagy, 2004). Making audit partner rotation mandatory is an intervention into longer engagement partner client relationships, the consequence of this in New Zealand is that without an interchangeable supply of clients in specialist industries is to erode the gene pool of specialist audit partners to becoming general partitioners (Interviewee 1, NonBig4, Interviewee 6, NonBig4) which may affecting the quality of earnings (Balsam et al. 2003). Managing partners from Big Four audit firms stated how audit partner rotation caused difficulties for the audit firms in filling all of the available roles and allocating the most suitable audit partner to the engagement with the appropriate industry knowledge, providing qualitative research evidence that audit partner rotation may not consistently increase audit quality.

5.2.7 Conclusions

Audit partners perceived that regulators in New Zealand are matching audit partner rotation regulations to larger countries that have large audit firms and increased partner resources. The consistent view amongst both Big Four and non-Big Four audit partners was that regulators are not 'right sizing' regulations to the New Zealand demographic environment and the audit partner resources available to New Zealand audit firms. Audit partners perceived that specialisation was eroding at the audit partner level while uplifting the skills of audit manager and team members.

The implications of audit partner rotation have been that there has been centralisation of audit services to larger audit firms with increased resources. Which has potentially

increased audit quality and improved compliance to IFRS. This research has provided qualitative evidence that there are only few audit partners in New Zealand capable of auditing a large complex entities. The problem that audit partner rotation creates in a small-scale economy is that due to extended cooling-off periods, audit firms are unable to allocate the most suitable audit partner to the engagement. The problem as perceived by some audit partners was that there isn't an interchangeable supply of clients for an engagement partner to rotate onto in New Zealand.

5.3 Planning and coordination mechanism

A significant finding from this study is that audit firms use general planning and coordination mechanisms, namely a matrix for audit partner rotation. Participants indicted audit firms use a complex matrix for audit partner rotation to ensure that the incoming audit partner has industry experience; institutional knowledge is retained within the engagement; and that the audit manager and team have relevant knowledge of the entities clients' specific matters.

This section of the chapter will discuss: Firstly, the differences between how Big Four audit firms and non-Big Four audit forms will be discussed. Secondly, how transitioning audit partners is part of the matrix. Thirdly, audit partners portfolios and capacity. Fourthly, The EQCR and cooling-off periods. Fifth, client specific matters and the audit team. Sixth, that cooling-off periods pose the biggest challenge to audit firms, and the last section will present the conclusions on the matrix of audit partner rotation.

5.3.1 Audit firm size and the matrix of audit partner rotation

Constructing a matrix for audit partner rotation can be directly related to the rostering of staff in human resource management. Rosters include assigning staff to specific roles based on the position they hold within the entity and skills and experience they have to effectively complete the designated role. Setting up matrix for audit partner rotation involves

a number of complexities. Firstly, a computer model needs to be generated to cover the myriad of different time-on periods and cooling-off periods for engagement partners, EQCR's, and other key audit partners. Then client information should be entered with all of the different roles that are required for each engagement. Secondly, the matrix needs to be able to identify engagement partner with relevant industry experience to replace the position of the engagement partner and EQCR. Prior literature states that engagement partners with industry specific knowledge perform higher quality audits. Evidence from this research confirms that in identifying potential engagement partners, audit firms look to provide an engagement partner with industry experience. Engagement partners and EQCR's should have similar levels of experience and age so that one cannot dominate the other when assessing significant judgements made (Beattie et al. 2004, Interviewee 5, Big4). Thirdly, the audit firms then look to infuse institutional knowledge into the engagement and an awareness of the client specific matters. For mid-size engagements this is done through the audit manager and engagement team, for large client entities the institutional knowledge and client specific knowledge is more likely to be held at the audit partner level.

Audit partners from non-Big Four audit firms provided evidence that to retain knowledge of the client specific matters in the audit, they constructed there matrix so that either the engagement partner, audit manager or EQCR has knowledge of the client specific matters that are unique to the entity. The institutional knowledge can therefore be determined to be within the audit firm and engagement team for mid-size entities. Non-Big Four audit firms are involved in auditing all of the three types of entities, though generally engagement partners from non-Big Four audit firms related audit partner rotation to FMC entities. Discussions regarding other key audit partners was absent from conversation with non-Big Four audit firms. What was discussed is that non-Big Four audit firms have to source engagement partners from other geographic locations around New Zealand and on occasion

Australia making the construct of a matrix either national or international in some instances and due to limited audit partner resources, needed to be extended to audit managers. This means that the matrix for non-Big Four audit firms have to cover five-year, six-year, and seven-year engagements and cooling-off periods of five-years, three-years, and two-years.

A frustration for Big Four audit partners was that there are only few high-profile clients in New Zealand, relegating them to auditing much smaller entities on the completion of auditing a much larger entity. The matrix for a large entity audit includes an engagement partner, a partner that is second in charge, and then a number of other audit partners dependant on the size and complexity of the entity being audited.

5.3.2 Transitioning engagement partners within the matrix of audit partner rotation

A significant difference in the way non-Big Four audit partners were transitioned into the next engagement was determined by the size of the entity being audited. The interviewee evidence from this research suggested that non-Big Four audit partners were rarely involved in engagements that involve multiple audit partners, though it can be considered that non-Big Four audit partners often consult tax, treasury, and governance specialists for advice on specific matters in the engagement. Audit partners from both non-Big Four and Big Four audit firms considered New Zealand audits to be predominantly made up of an engagement partner, EQCR, audit manager, and team. With both the engagement partner and EQCR having to be licensed and observe cooling-off periods, engagements of this size cannot facilitate the grooming of an incoming audit partner into the signing partners role position. The transitional process where there is not multiple partners involved is having conversations with the exiting incumbent partner around client specific matters and the material threats to the entity. Prior to research being done by Dodgson et al. (2020) and Pittman et al. (2022), it was assumed that rotating the engagement partners was a standalone event which appears to be relatively true for most auditor engagements in New Zealand. The effect this has is that the

incoming engagement partner can provide a ‘fresh perspective’ to the audit engagement without being influenced by the incumbent audit partner on the judgements and treatments that have been made.

Big Four audit firms start the transition process with managing partners identifying several candidates for the upcoming engagement based on industry knowledge and experience. Pittman et al. ‘s (2022) research found that audit firms groom a partner into the signing role position. This research found some evidence to support this, Interviewee 2, Big4, 4Big4 stated that the audit firm does know who they would prefer the incoming partner to be. Multiple Big Four audit partners confirmed the process set out in Dodgson et al. (2020) research which stated that Big Four audit firms provide clients with a selection of audit partner to choose from with some audit committees wanting to interview all of the potential candidates while others prefer the incoming engagement partner to attend meetings to ensure a working relationship can be achieved. A Managing partner stated that in matching the EQCR to the engagement partner imbalances in age and experience should be considered so that a more experienced engagement partner could not dominant the EQCR is assessing the judgments that they have made.

Based on research done by Dodgson et al. (2020) this study investigated the transition process of audit firms. The findings from this study confirmed a number of the processes that Dodgson et al. (2020) describes. Then added to this body of knowledge by providing evidence that audit firms look to match personalities in the transitions process. It is important that engagement partner and client has a productive working relationship, the ease of this relationship can be of benefit in gathering the information required to complete the audit (Dodgson et al. 2020: Richard, 2006). A problem that the engagement partner faces is that they are required to sceptical and objective of a clients treatments of accounting standards, yet they are also want to retain the client, be able to negotiate fees and add value to the entity

they are auditing. The nature of an audit engagement is that there will inevitably be disagreements and potentially confrontations in auditor negotiations, with the engagement partner having to challenge the entity on their treatments of accounting standards. The outcomes of these negotiated settlements can be determined by the relationship that the engagement partner and the client have (Beattie et al. 2004). Audit firms in assessing personalities do so on the basis that the engagement partner will a good cultural fit with the client and be able to resolve any potential issues, so they don't have concerns in issuing an unqualified audit opinion. The resolution of issues can be determined by how an aggressive financial position the client has taken. It should be assessed that entities taking highly aggressive financial positions is rare from the low rate of audit failures (Francis, 2004). The difficulty for an engagement partner in this position is that they have to constrain an entities aggressive financial position whilst maintaining a relationship with the client, so they are not obstructed in the gathering information in future audits or loose the client from not being able to negotiate a settlement on specific judgements that have been made. This could be described as an extreme circumstance in allocating an audit partner to an engagement. The consequence of limited partner resources is that New Zealand audit firms may not have many alternatives in allocating an engagement partner. Interviewee 8, Big4 described a circumstance where a less appropriate engagement partner was allocated to an engagement, due to audit partner rotation regulations and a lack of audit partner resources, which should be of concern to regulatory agencies.

5.3.3 Audit firms consider an audit partners entire portfolio before allocating them to an engagement

Auditing a large complex entity takes a significant amount of planning. The acceptance of a client can be dependent on whether a licensed audit partner has the industry knowledge, experience, and capacity in their portfolio. Human resource development

provides literature on how organisations develop the expertise of their employees to meet the organisations objectives (Torraco and Swanson, 1995). To expand an audit partners portfolio, audit firms assign them to different positions in the engagement to build up their knowledge and experience, by doing this they are able to groom their audit partners into the engagement partners positions in larger more complex entities (Pittman et al. 2022, Interviewee 12, Big4). This grooming makes the audit partner the preferred candidate for the engagement partner position, though this may not eventuate if the client does not perceive them to have the right chemistry for a workable relationship. Managing partners oversee the portfolios of audit partners and liaise with employees that implement the global rotation database. What should be considered is that even in the larger audit firms they are still dealing with a finite group of audit partners and for entities that require specialization that group is even smaller (Interviewee 5, Big4,12, Big4). This study has identified a complex structure for inducting audit partners into specific industries and slowly building up their portfolios so they can eventually take on larger more complex clients.

5.3.4 Rotating the EQCR in a small-scale economy creates problems for the audit firm

Audit firms are required to rotate the EQCR on all NZX, FMC, and OAG audits with varying applicable timeframes. EQCR's need to have industry experience so that they can competently challenge the engagement partner and members of the audit team (PCAOB). As stated by Interviewee 5, Big4, 6, NonBig4 the matrix of audit partner rotation should identify any experience and power imbalances and identifying the most suitable person for the position. The key difference between the engagement partner and EQCR's in the matrix are the time-on periods and cooling-off periods that have to be observed. Before 2018, EQCR's were required to observe two-year cooling-off periods, this was then extended to three-years for NZX, FMC, and OAG entities. The purpose of cooling-off periods for engagement partners is to increase independence and reduce familiarity between the engagement partner

and the client. It is also perceived that cooling-off periods bring forth an invigorated ‘fresh perspective’ on an engagement partners return to the engagement.

The reasoning for EQCR’s to observe cooling-off periods is not so clear. The reasoning from a regulator’s perspective could be that they don’t want the EQCR’s switching directly into the engagement partners position after completing their engagement as the EQCR. This perception could be assimilated to the perspective that management are able to influence an engagement partner decisions in long tenures. Implying that the engagement partner may influence the EQCR’s perceptions on judgements made and treatments of accounting standards. Thus, inhibiting the outgoing EQCR’s ability to bring a ‘fresh perspective’ to the audit engagement when they became the engagement partner.

The EQCR’s role in an engagement is to challenge the engagement team and discuss the key judgments made with the engagement partner, they are not client facing and do not interact with the client. Some audit partners in this research were critical of extended cooling-off periods for EQCR’s and questioned the reasoning behind EQCR’s having to observe cooling-off periods. Based on the perception that overfamiliarity between the EQCR and client does not exist and that their accumulated knowledge of the client could increase audit quality. Regulators could argue that an engagement partner should not move into the position of being EQCR because a relationship bias may still exist. This research does not advocate for no cooling-off periods for EQCR’s but does argue that regulators should provide the reasoning for extended cooling-off periods.

5.3.5 Institutional knowledge is kept within the audit team

The purpose of creating a matrix is to ensure that there is consistency of knowledge retained within the client engagement. Audit partners did not provide evidence that the matrix of audit partner rotation included individual team members. But did provide the significant perspective that the changing of the audit team was the biggest threat to audit quality

(Interviewee 1, NonBig4, 11, NonBig4, 12, Big4, 13, Big4). What needs to be differentiated is that in a large client entity audit the knowledge of client specific matters is held by the multiple audit partners involved in the engagement. In smaller entity audits the knowledge of client's specific matters is kept within the audit manager and audit team. Litt et al. (2014) research presents the possibility that changing the engagement partner and EQCR may have little impact on audit quality. This concept is at odds with the regulatory approach of singling out the engagement partner for rotation and requiring engagements partners name stated on the audit report. Engagement partners do take overall responsibility, yet what must be considered is that an audit is a team effort involving many people across different areas of the entity and audit team (Interviewee 8, Big4). This practical reality is that in smaller to mid-size engagement the audit work is being carried out at the audit manager team level (Interviewee 1, NonBig4). Audit partners provided the perspective that the quality of those people and the work they carry out determines the quality of the financial statements, with the engagement partner and EQCR being involved at the entity, commercial risk level.

Audit partners considered that the fundamental knowledge in an audit was kept within the audit team. The subject of audit firm rotation was a constant theme throughout this research with some engagement partners seeing this as inevitable (Interviewee 7, Big4). Interviewee 4, Big4 perceived the first year of an audit firm auditing an entity as the hardest. The issue of engagement partners signing the audit report and regulators being able to conduct criminal and civil prosecutions against the engagement partners is potentially out of congruence when the construct of an audit is taken into consideration. Carcello (1992) states that the characteristics of the audit team are important to audit quality. This research has found that the practical reality is that the audit manager and team complete the audit work. The quality of the work carried out is dependent on the quality of information supplied by the entity. In larger client entities the engagement partner can be considered to be significantly

removed from the transactional data being obtained from the client. This research identified that it is the audit manager who is the go-to person for the management of the firm and is more likely to have closer relationship with management. Making them an integral part of the matrix for mid and smaller sized engagements. Audit partners perceived that audit partner rotation has resulted in engagement partners being more dependent on the work carried out by the audit manager and team in the first year of the engagement. And more reliant on the audit managers and teams' relationships with client due to the periodic breaking of the engagement partner client relationship. That engagement partner is singled out to take accountability does potentially create additional assurance that the financial statement is less likely to be misstated. The argument put forward by participants in the study is that singling out the engagement partner is at odds with the construct of an audit and the many variables that go into producing audited financial statements and the contractual basis of audit firms providing reasonable assurance.

5.3.6 Cooling-off periods are the biggest obstacle for New Zealand audit firms

A significant problem in constructing a matrix for audit partner rotation is that audit firms have to manage a myriad of different rules for engagement partners, EQCR's and other key audit partners. Audit partners in this study were in agreement that cooling-off periods in the New Zealand were too long and that the threat of overfamiliarity did not exist after a cooling-off period of three-years. They also believed that cooling-off periods for EQCR's were too long and could be reduced to two-years to match other key audit partners.

Interviewee 13, Big4 questioned the relevance of extending cooling-off periods from three-years to five and whether these timeframes were suitable for the New Zealand economy with limited partner resources. Interviewee 6, NonBig4 potentially provided the answer to this by stating that the suitability of timeframes should be determined by the availability of audit services. New Zealand is currently experiencing an auditor supply shortage with the

government being forced to pass the Annual Reporting and Audit Time Frames Extensions Legislation 2021 giving OAG entities a two-month extension on filing their audited financial statements. From December 2023 OAG entities will also be able to apply for a reduction to the cooling-off periods for the engagement partner. On acceptance by the regulator, engagement partners' cooling-off periods will be reduced from five-years to three-years (XRB, 2022). Audit partners stated that certain entity types were struggling to gain audit services such as charities and not-for profits, indicating a shortage of audit firms. What this suggests is that reducing cooling-off periods will increase the availability of licensed audit partners to complete audits. Making increased cooling-off periods levers for audit partner supply in New Zealand.

5.3.7 Conclusions

The purpose of setting up a matrix for audit partner rotation is to manage the myriad of different regulations that have been put in place. The complexity of the matrix comes from (1) replace the incumbent partner with an audit partner with industry experience (2) managing an audit partners portfolio and capacity (3) retaining institutional knowledge in the engagement, and (4) have an audit manager and audit team members present in the engagement that have knowledge of an entity's clients' specific matters. Audit partner agreed that extended cooling-off periods were the biggest challenge to audit firms and that certain entity types were struggling to gain the services of audit firms. A significant conclusion from this research is that extended cooling-off periods in a small-scale economy are levers for market concentration and that by reducing cooling-off periods this will allow audit firms to better serve the entities that are legally required to be audited.

This research followed Dodgson et al. (2020) research in investigating audit partner transitions. Most of the findings from this study concurred with Dodgson et al. (2020), then but added to by finding that audit firms match personality types when assigning engagement

partners to clients and experience levels when matching the EQCR to the engagement partner. The purpose of matching personality types is so that an engagement partner can constrain a client's aggressive financial position while also facilitating the ease of information transference from the client to the audit team to ensure audit quality. Audit firms match age and experience levels between EQCR's and engagement partners so that an engagement partner (and vice versa) cannot dominate an EQCR when making significant judgements and so that the EQCR can make a credible challenges to the engagement partner and team without being at experience or age disadvantage.

5.4 Relationships between engagement partners and their clients

The purpose of audit partner rotation is to periodically end the engagement partner client relationship. Beattie et al. (2004) researched auditor client negotiations finding that primary auditor client relationships are important for gaining a quality. Following this research this study looks to explore the implications of audit partner rotation on auditor client negotiations.

This section of the chapter will discuss: Firstly, the impact of audit partner rotation on auditor-client relationships in the first years on an engagement. Secondly, the 'fresh perspective' and material risk assessments. Thirdly, that audit partner rotation leads to internal and external challenges. Fourthly, audit partners perceive multiple aspects of familiarity. Fifth, how audit partner rotation effects the relationship between the engagement partner and the management of the entity. Sixth, that directors perceive audit partner rotation as good governance. Seventh, that employees in client entities are constantly changing, and lastly the conclusions on engagement partner client relationships.

5.4.1 Audit partners face a knowledge and experience imbalance in the first year of the engagement

Researchers that argument against audit partner rotation do so on the basis that the financial statements are more likely to be misstated in the first few years of an audit partners engagement, while the engagement partner builds up knowledge and experience. This is a critical issue of audit partner rotation, audit partners in this study confirmed what was already known in research by providing evidence that in the first year of the engagement the audit partner is on a learning curve (Interviewee 2, Big4, 4, Big4), that this is a period of building key relationships (Interviewee 7, Big4), learning the big picture stuff (Interviewee 9, NonBig4) and potentially asking a lot of stupid questions (Interviewee 4, Big4). Interviewee 5, Big4 explains: *“That in the first year of performing an audit, an audit partner is not going to be as familiar with the organization and the affordable risk, they won't perform as higher quality audit”*. The reference to affordable risk relates to the threats that an entity faces, and that in the first year of an audit partners engagement they are not yet familiar with the clients' specific matters which can potentially decrease audit quality. Concerningly, Interviewee 2, Big4 states that in the first year of an engagement an audit partner is likely to accept management interpretations of the key assumptions that have been made. This has significant implications in the auditor negotiations. What audit partners were communicating was that there is a knowledge and experience imbalance in the first year of an audit partners engagement creating a power imbalance in the relationship between the engagement partner and client. This knowledge and experience power imbalance can lead to management being able to exploit the engagement partners inexperience to potentially gain financial rewards.

The second year of the engagement is when the audit partner looks to rectify any mistakes that have been made in the first year of the engagement and address the relationship power imbalance. Research does not provide specific evidence on the second year of an audit

partners engagement. This study contributes to research by describing this process.

Engagement partners in the second year of the engagement starts picking up on things they have missed in the first year (Interviewee 6, NonBig4), the focus goes from the big picture to learning the details of the entity and gaining a greater understanding of their client specific matters (Interviewee 5, Big4). Interviewee 9, NonBig4 states that the second year is when you might fix anything that you may have got wrong, confirming the research perspective that the financial statements are more likely to be misstated in the first year of an engagement. Participants described how in first years of an engagement the engagement partner is highly reliant on the knowledge retained amongst the engagement team and the relationship held between the audit manager and the client (Interviewee 4, Big4, Interviewee 11, NonBig4). Auditors challenge management in auditor negotiations. Interviewee 2, Big4 states how in: *“The second year you go this is not working, your assumptions aren’t working”*. This statement summarizes how the engagement partner in the second year of the engagement looks to rectify the power imbalance created by audit partner rotation by directly challenging the management of the entity on the assumptions that they have made. The implications of audit partner rotations are that management may take a more aggressive interpretation of the accounting standards in the first year of an audit partners engagement to gain financial rewards, reliant on an information and experience imbalance occurring through the transitional process. Critically, audit partner rotation puts the engagement partner in a position of unease to challenge management on the assumptions that they have made. The engagement partner in the second year has to then overcome this period of unease and show courage by challenging management on the assumptions they do not agree with.

5.4.2 The ‘fresh perspective’ is a re-assessment of the material threats that may threaten the entity

The purpose of implementing of audit partner rotation regulations is based on two definable concepts (1) a sociological perspective that attitudes and behaviours change in longer engagements (2) and that the incoming audit partner will bring a ‘fresh perspective’ to the audit engagement. The argument against mandatory audit partner rotation and a ‘fresh perspective’ is that due to the incoming partner being less informed about the client there is an increased likelihood that they may not identify a financial reporting problem. This study provided research evidence that the financial statements are more likely to be misstated in the first year of audit partners engagement. The argument for audit partner rotation and a ‘fresh perspective’ is that the incoming engagement will carry out a powerful peer review of the exiting engagement partners work (Lennox et al. 2014). Audit partners in this study provided the perspective that audit partner rotation resulted in them questioning balance sheet items and the judgements of exiting partners whilst increasing their ability to challenge the management of the firm.

Researchers that argue in favour of audit partner rotation, do so on the basis that the incoming partner will bring a ‘fresh perspective’ to the engagement, increasing audit quality by detecting and correcting mistakes in the financial statements. This statement may be true but implies that audit partner rotation is a stand-alone event. Dodgson et al. (2020) provides evidence that audit partner rotation is not a stand-alone event but is managed by the audit firm with the incoming engagement partner being involved in the audit process for as long as eighteen months to two years before they become the engagement partner, this research concurs with this literature providing further evidence that audit partner rotation is not a stand-alone event.

Dodgson et al. (2020) states that incoming audit partners may shadow the incumbent partner prior to becoming the engagement partner with additional resources being applied to larger more complex engagements. Pittman et al. (2022) provides evidence of connections between the incoming audit partner and the incumbent engagement partner and that audit firms may choose to groom an incoming audit partner into the engagement partner's position. This research finds evidence that on large client entity audits the engagement partner will have an audit partner that is second in charge and likely to ascend to the engagement partner's position. Pittman et al. (2022) states that an audit partner that is familiar with the entities client specific matters and has already established relationships, is likely to ascend to the engagement partner's position. That an incoming partner is involved in an audit for up to two years before hand brings into question whether they can bring a 'fresh perspective' to the audit engagement, it also implies that they are able to contribute and be involved in the judgements that have been made (Interviewee 13, Big4). This process allows the incoming audit partner to question the incumbent partner on the treatments of accounting standards and how they have determined that they are the correct. While this process may be highly valuable for the incoming partner it also provides a period of time when the incumbent partner is able to persuade the incoming partner that the judgements, they have made are the correct ones and dissuade the incoming partner from taking a fresh approach to previous judgments made.

There are now three sets of research that have found that audit firms manage audit partner rotation and that it is not a stand-alone event (Dodgson et al. 2020; Pittman et al. 2022). This brings into question prior research done by Myers et al. (2003), Carey and Simnet, (2006), Chi and Huang, (2005) and Chi et al. (2009) that have tried to discover the effects of audit partner rotation based on the principle that audit partner rotation is a stand-alone event and used quantitative measures, such as the proxies of abnormal accruals, going

concern, and misstatements to determine if there have been changes to audit quality. That audit partner rotation is not a stand-alone event explains why these researchers were not able to gain conclusive results. This highlights the importance of qualitative studies and the importance of having conversations with professionals in the area of research that is being studied.

Audit firms manage audit partner rotation to ensure audit quality in the engagement. This practice potentially inhibits the incoming engagement partner from bringing a ‘fresh perspective’ to the engagement. Whether regulators are aware of it or not they have countered audit firms inhibiting the ‘fresh perspective’ by requiring engagement partners to sign the audit report which can have a negative reputational consequences in the event of an audit failures. Though signing the audit opinion can also have positive reputational implications for the successful completion of larger more complex audits. In the event of a corporate collapse or where fraud can be established engagement partners can also be held personally liable and face criminal or civil prosecutions. What this creates is an environment of ‘individual partner risk’ motivating the incoming engagement partner to re-examine the material risks that threaten the entity and not take for granted the material assessments that have been done in the past. The construct of ‘individual partner risk’ also shifts the litigation risk away from the audit firm, placing increased responsibility on the engagement partner in the event of an audit failure. The effect of ‘individual partner risk’ is that it emboldens the engagement partner to challenge other or senior partners interpretations of accounting standards as well as being less likely to accept an aggressive financial position held by management, changing the relationship dynamic. Audit partners in this research were in agreement that the ‘fresh perspective’ leads to positive outcomes in the audit engagement, providing evidence that the incoming engagement partner will take the opportunity to reevaluate the material risks that the entity faces (Interviewee 13, Big4), questions the previous judgements made (Interviewee

12, Big4), use their experience from other engagements to question the treatments of accounting standards (Interviewee 4, Big4), increase the challenge that the engagement partner brings to the management of the entity (Interviewee 2, Big4) and change the relationship dynamic in auditor negotiations.

5.4.3 Audit partner rotation leads to internal and external challenges

The relationship between an auditor and a client is one where the auditor, when necessary, has to hold the management of the entity to account on their interpretations on the accounting standards and the judgements that they have made, which can potentially lead to conflict between the two parties. The engagement partner in this circumstance has to consider whether the impact of the management's interpretation is material to the entity and whether it would influence the audit opinion (Interviewee 6, NonBig4). If the engagement partner determines that the interpretation is material, then they must be prepared to have a courageous conversation with the client even when the potential change to that interpretation may place the entity in a difficult situation (Interviewee 2, Big4) such as reporting a loss instead of a profit. In this circumstance the relationship between the engagement partner and the client can have a significant impact of the potential outcome of these negotiations (Beattie et al. 2004). A newly rotated on engagement partner in this situation faces a power imbalance due to their lack of knowledge of client specific matters, inhibiting their ability to challenge management in auditor negotiations and having to rely on the audit manager and teams' relationships in mid to small-size engagements and other audit partners in large client entity audits.

Challenging a client on the assumptions that they have made is the external outcome of the audit. Lennox et al. (2014) provides evidence of engagement partner internally peer reviewing each other's work. This study confirms a peer review process providing research evidence of incoming engagement partners reassessing the risks that may threaten the entity

and questioning the material benchmarks that have been applied (Interviewee 12, Big4, 13Big4). So far what has been discussed is the challenge that auditors present to the client. Changing engagement partners leads to the incoming engagement partner challenging the incumbents' judgements and decisions which can lead to changes in relationships between audit partners and power dynamics within the audit firm. Interviewee 7, Big4 explains: *“One of the internal challenges is obviously having the confidence to come to a different view than your previous partner had, which happens a lot”*. The foreseeable difficulty for a newly promoted audit partner is challenging a senior partner in the audit firm that has a distinctive power advantage, potentially dissuading the junior partner from challenge the senior partner should the junior audit partner determine that challenging the senior audit partner could have negative career consequences. Following Lennox et al.'s (2014) research and assuming *ciribus* in audit partner relationships, audit partner rotation should promote the incoming engagement partner challenging the assumptions and judgements made by the incumbent's partner. Audit partners in this study perceived that the incoming engagement partner will bring their experiences and knowledge from previous client engagements to bare when assessing the material risks of the entity and judgements made by the incumbent engagement partner (Interviewee 4, Big4, Interviewee 13, Big4). Making audit partner rotation an audit quality increasing exercise from the continual reassessment of the material assumptions made by the entity.

The New Zealand regulatory agency has created a regulatory environment of 'individual partner risk' this environment has meant that both the engagement partner and audit firm face consequences in the event of an audit failure. Audit firms generally have increased resources compared to an individual audit partner. The reputational damage done to an individual engagement partner from an audit failure may mean that they will not be able to work in the industry again and was described as a highly personal matter (Interviewee 12

Big4). The creation of ‘individual partner risk’ by the regulatory agency changes relationships within the audit firm. Audit partners need to consider the risk to themselves when deciding whether to challenge the judgments of the exiting partner. The combination of regulatory actions that could be taken by the regulator, motivates audit partners not to blindly accept the judgements that has been made in the past but to be sceptical of the judgements promoting a revaluation and confirmation process to evaluate how those judgements have been derived at before challenging the judgement if the incoming audit partner disagrees with the exiting partners interpretation.

The combination of audit partner rotation and other regulations changes the relationships not just between the engagement partner and the client but also impacts partner to partner relationships. An additional consequence of ‘Individual partner risk’ is that not only does it motivates junior partners to challenge senior partners on the judgements they have made but creates an environment where the engagement partner is less likely to acquiesce to pressures within the audit firm. The growing power of large corporate entities has been of concern to many people since the 1980’s (Frick, 2018) gaining increased political power (Young et al. 2020). The dominance of Big Four audit firms and their alignment with large corporate entities is of serious concern in both the UK and US (Lagace, 2013; Williams-Alvarez, 2022). Regulators by creating ‘individual partner risk’ are perceptibly altering the large corporate entity, large audit firm relationship by making the engagement partner personally accountable in the engagement. Because of the reputational risk the individual partner faces they are less likely to give into pressures from large corporate entities and except the aggressive treatments of accounting standards. This alters the power dynamics within the audit firm, the successful challenge of an interpretation may elevate that partner within the firm gaining prestige and financial rewards, though power structures in audit firms

are likely to be complicated and could result in the opposite effect especially if it effects a large powerful entity.

5.4.4 Audit partner rotation ends the relationship between the engagement partner and the client

The ethical principle of audit partner rotation is based in social psychology, which provides evidence of changing attitudes and behaviours in longer relationships. Based on these principles, the construct of a ‘familiarity threat’ has been developed that implies that long relationships lead to engagement partners been susceptible to the opportunistic interpretations of accounting decisions by management. This research provides evidence that most of the audit partners perceived familiarity to be a risk when engagement partners carry out engagements for years and years, though some partners were critical doubting that audit partner rotation was suitable for the New Zealand environment based on the size of the economy (Interviewee 1, NonBig4, 5, Big4, 6, NonBig4). An interesting finding in this study was that audit partners perceived multiple dimensions of familiarity, the first being that over familiarity may cause engagement partners to miss things in the engagement and that familiarity may inhibit an engagement partner from asking challenging questions. Interviewee 6, NonBig4 assertively puts it as: *“Because it's a judgment call someone should challenge that judgment and if someone is too familiar, they may not challenge”*. This statement confirms the social psychology perspective that long relationships influence attitudes and behaviours, in this instance decreasing the engagement partners willingness to challenge judgements. That engagement partners are likely to miss things is more likely to come from the engagement partners being susceptible to a self-serving bias of believing that they know all the threats that an entity faces.

Audit partners in this study provide research evidence that agrees with both sides of the argument surrounding audit partner rotation. Firstly, the position held by regulators that

long relationships threaten an engagement partners ability to challenge aggressive financial positions and secondly, researchers that argue that familiarity with a client's specific matters enhances the engagements partners abilities to provide a higher quality audit. In direct contrast to over familiarity causing audit partners to potentially miss something, they also provide the perspective that a lack of familiarity is a risk to audit quality. This aspect of familiarity is where an engagement partner gains an insight into the entity so that they have a greater understanding of audit and fraud risks. Interviewee 1, NonBig4 explains: "You do get an awful lot of accumulative audit knowledge of clients when you are working on them, you know where the risks are, you know the history of some of the transactions they have been involved with in the past". This implies a deeper understanding of the entity and the risks they may be exposed to. A common proxy used to measure audit quality in research is abnormal income increasing accruals. An historic understanding of an entities transactions gives the engagement partner an understanding of what the acceptable level is of an abnormal income increasing accrual which could safeguard the investor against aggressive financial decisions made by management. Audit partners perceived that the biggest risk to audit quality was changing the entire audit team, directly relating this to the loss of institutional knowledge and the disruptions to relationships. Social psychology provides evidence of attitudinal and behavioural changes in long relationships. Regulatory agencies associate these behavioural traits negatively towards a perceived 'familiarity threat' which is confirmed by audit partners. The contrasted viewpoint in social psychology is that these behavioural changes can also positively impact relationships through trust. Increased trust in a relationship can lead to a greater insights into the entity from individual actors in the organisation being willing to divulge more information's giving the engagement partners a greater understanding of their client specific matters, with the consequence being increased audit quality (Wilson et al. 2017).

5.4.5 Audit partner rotation disrupts the relationship between the engagement partner and management

Literature on auditor client relationships focuses on how long tenures result in management being able to influence the engagement partner into accepting aggressive financial decisions. The reality as perceived by New Zealand audit partners is that the engagement partner and audit teams need good relationships with management to ensure a quality audit. This research provides evidence that the management of the entity view audit partner rotation as an inconvenience because of the practical reality that they have to teach everything again to the incoming engagement partner who is likely to ask a lot of stupid questions (Interviewee 4, Big4, 6, NonBig4, 8, Big4). Interviewee 4, Big4 explains: *“The reason I’m asking questions is because I’m now the partner and I need to understand it.... that’s part of rotation”*. Audit partners provided the perspective that the incoming partner has to spend a lot of time asking questions about balances that have already been signed off by previous partners, potentially for several years, frustrating and confusing the client as to why the engagement partner is interested in balance sheet items that have been there for years.

This research provides evidence of how management like consistent relationships, across the whole engagement team. Because from a management perspective they want auditors that know how their entity works (Interviewee 3, NonBig4). Engagement partners do not interact with management on a daily basis. Most interactions occur between audit manager and team that are completing the practical work of proving balances, testing transactional data and checking contracts, while the engagement partner and EQCR are more involved at the entity, commercial risk level (Interviewee 1, NonBig4). Contrary to the focus of a lot of research it is the audit manager that has a close relationship with management, they are likely to see them every day and can be described as the go to person when management have questions or problems (Interviewee 1, NonBig4, 5, Big4). In line with the management

of the entity the audit firm wants consistency of skills and knowledge within the engagement and the continuance of established relationships that ensure a quality audits (Interviewee 1, NonBig4, 2, Big4, 4, Big4, 5, Big4).

5.4.6 Boards of directors perceive audit partner rotation as a best practice

The establishment of a regulatory regime and audit partner rotation has had a significant effect on audit partners and the directors of New Zealand entities. Directors can be held personally liable and be sued for a breach in their duties (Rankin, 2022). The duties on a director include ensuring the compliance of the financial statements and that they represent a true and fair view of the entity (FMA, 2018). A number of participants in this study perceived that there was a disparity between the obligations of management (Interviewee 12, Big4, 13, Big4) and those of the directors and auditors (Interviewee 8, Big4, 9, NonBig4). Conceiving that directors and auditors have ‘skin in the game’ in the event of corporate failure.

This research has provided evidence that the management of the entity perceive audit partner rotation to be an inconvenience. In contrast to this the perceptions of audit partners in this study were that directors perceive audit partner rotation to be good governance.

Participants made reference that some directors had little understanding of audit partner rotation but the boards that do wanted to implement best practices (Interviewee 4, Big4).

Interviewee 13, Big4 explains: *“There the ones pushing for the quality, they’re the ones pushing for the right disclosures and the papers supporting judgments..... it’s their responsibility to assess the independence of the auditors”*. It is a director’s responsibility to ensure that the audit firms meet its compliance requirements (FMA, 2020). From a directors’ perspective audit partner rotation achieves two governance goals (1) that it increases the independence of the audit firms and (2) that the material risks to the entity have been re-assessed.

A positive from the new regulatory regime is that it has increased the communications between engagement partners and directors. Interviewee 8, Big4 stated that directors are now seeking time alone with the engagement partner. This can be interpreted as directors seeking additional assurance that their obligations to the investors are being met. Interviewee 7, Big4 explained how the establishment of a regulatory regime has had the effect of aligning the goals between the directors and auditors to protect the shareholders of the entity. What the regulatory regime has achieved is to change the relationship dynamic between the engagement partner, directors and management of the entity. The perceptual difference is that due to directors and auditors having 'skin in the game' directors are now acting as intermediaries in auditor negotiations and have an increased understanding of their responsibilities to support the audit function (Beattie et al. 2004). This research provides evidence that the new regulatory regime and audit partner rotation has strengthened the relationship between directors and auditors by increasing their responsibilities making both parties more aligned in protecting shareholder wealth.

5.4.7 Employees in client entities are constantly changing

The passing of the Sarbanes Oxley Act in 2002 resulted in the tightening of audit partner rotation regulations and increasing of cooling-off periods in the US. New Zealand started implemented audit partner rotation regulation in 2004. In congruence to this there has been generational change in workplace demographics. This demographical change is that the workplace is now dominated by Millennials as opposed to Generation X (Martic, 2023). This generational change has resulted in employees spending less time with individual employers, on average five- years. This has significant implications for audit partner rotation policies and cooling-off periods. This research provides evidence that due to this generational change it is very unlikely to have consistency of employees amongst directors, managers or audit teams. Which has resulted in a natural control of the familiarity risk (Interviewee 2, Big4, 3,

NonBig4, 6, NonBig4, 12, Big4, 13, Big4). Interviewee 6, NonBig4 explains: “I had to come off one of my jobs last year, where the CFO had changed and the complete board was different, I didn't really know any of those people at all, but I would have been too familiar”. Evidence from this research poses specific problems for regulators. The generational change that has occurred directly brings into question the regulators reasoning for extended cooling-off periods but not audit partner rotation because audit partner rotation can be considered an audit quality increasing exercise.

Audit partners are subjected to a five-year cooling-off period following an engagement for NZX and FMC entities. The reasoning that regulators give for audit partner rotation and extended cooling-off periods is that a self-interest threat might develop from an individual concern about losing a longstanding client or an interest in a close personal relationship may develop between a member of the senior management or those in charge of governance (XRB, 2022). The interpretation of this is that a long and close relationships can affect an engagement partners judgement and that the regulatory agency considers a cooling-off period of five-years sufficient time for this threat to be extinguished. The problem with the regulatory reasoning is that according to statistical evidence supplied by the US Department of Statistics, research information and evidence provided by audit partners in this research is that this threat no longer exists or has been significantly reduced, with a natural control developing from a generational change that prevents long relationships developing in the engagement leading to the conclusion that five-year cooling-off periods are no longer necessary and should be revised by the regulatory agency.

5.4.8 Conclusions

This research investigated the first and second year of the audit partners engagement providing qualitative research evidence that audited financial statements are more likely to be misstated in the first year of the engagement and that audit partner looks to rectify any

mistakes made in the second year of the engagement. This research concurs with prior research that due to an engagement partner not being as familiar with an entity's client specific matters, engagements partners are more accepting of managements interpretations of accounting standards in the first year of an engagement which suggest management are more likely to management earnings while the engagement partner builds up knowledge and experience. The 'fresh perspective' of the incoming audit partner counters the loss of client specific knowledge in the first year of an engagement and can be described as a critical reassessment of the material risks that threaten the entity and previous judgements that have been made. The implications of this are that audit partner rotation and the 'fresh perspective' becomes a governance issue ensuring independence and that the risks an entity faces are continually being re-assessed.

Audit partners in this research confirmed the social psychology perspective that long relationships lead to behavioural changes between engagement partners and clients. Finding that engagement partners are less likely to challenge managements treatments of accounting standards in auditor client negotiations when they have become over familiar with the client. However, it can be concluded that engagement partners face an information's and experience imbalance in the first year of an engagement creating a power imbalance that favours the management of the entity in auditor negotiations. Regulators have introduced 'individual partner risk' into the audit engagement by (1) making audit partner rotation mandatory (2) requiring audit partners to sign the audit opinion for NZX and FMC audits, and (3) making the engagement partner liable in criminal and civil prosecutions. This has effectively isolated the engagement partner from the audit firm in event of audit failure or corporate collapse. Regulators have changed the relationship dynamics both internally and externally by creating 'individual partner risk'. Internally this means that the engagement partner is more likely to

challenge other or senior partners judgments, externally this means that the engagement partner will be less likely to except judgements by the entity that can be considered material.

This research has provided evidence that auditors are often going into an engagement where there has been significant change within the entity. Which is backed up by data from the US department of statistics and research evidence that Millennials changes jobs on average every five years. This has significant implications for cooling-off periods. A generational change has resulted in long auditor client relationships becoming less likely to occur. This research has concluded that extended cooling-off period pose the biggest problem to audit firms in New Zealand. This finding has significant implications to regulators. Regulators should consider reducing cooling-off periods to increase the availability of licensed audit partners.

Chapter 6: Conclusions, limitations and future research.

The purpose of this research was to gain the perspectives of audit partners on the implementation of audit partner rotation regulations. This chapter of the research will: Firstly, draw conclusions to directly answer the research questions. Secondly, it will highlight how the observations made in this research can contribute to theory. Thirdly, it will explore areas of future research, and fourthly it will explain the limitations of this research.

6.1 Conclusions

The first research question: “How do audit partners perceive the imposition of mandatory audit partner rotation regulations?” can be answered by communicating the shared perspectives of audit partners on the identified research problem.

This research found that regulators design regulations based on their perceptions of the environment they are regulating. The audit partner rotation regulations that have been implemented in New Zealand are designed for large-scale commercial entities and large-scale audit firms. This research has provided qualitative research evidence that reduced time-on periods are suitable to large client entity audits because they have increased institutional knowledge present in the engagement. New Zealand has mainly small to medium-sized commercial entities with a few commercial entities and a relatively small number of audit firms. The reason audit partners perceived audit partner rotation regulations to disproportionately effect small and mid-sized audit firms is because the regulations are not designed for small and mid-sized audit firms and have not been ‘right sized’ to meet New Zealand’s demographic environment. What audit partners expressed was that the regulatory approach is disconnected from the practical realities of New Zealand audit firms. Which has resulted in some small and mid-sized audit firms not having sufficient audit partner resources to stay in the domestically registered audit market, which has created the perception that the current regulatory environment may not be sustainable.

The implications of introducing regulation based on standardization rather than on the demographic environment is that audit firms have to compensate for the regulatory disconnection, to the practical reality of limited audit firm resources. Positively mandatory audit partner rotation has led to a more even distribution of skills amongst audit partners and audit team members, negatively it leads to audit firms not being able to appoint the most suitable audit partner to the engagement. Audit partners perceived that mandatory audit partner rotation leads to increased reliance on the audit manager and audit team. Audit quality at this level could be assumed to be constant or improving. Appointing an engagement partner with no or limited industry experience is a threat to audit quality and requires the audit firm to apply more resources to the engagement to ensure that audit quality isn't compromised at the commercial risk, entity level.

To second research question "What are the implications of making audit partner rotation mandatory in New Zealand?" is answered by how audit firms have responded to the imposition of mandatory audit partner rotation regulations.

New Zealand has implemented a complex structures of audit partner rotation policies, in response to this regulatory structure audit firms have set up planning and coordination mechanism (e.g., matrixes and logs) to manage audit partner rotation. The purpose of a matrix is to provide practical solutions to the myriad of regulations that have been introduced, while also incorporating the more nuanced aspects of audit partner rotation. The practical application of a matrix is to ensure that there is institutional knowledge and client specific knowledge present in the engagement. It should also determine who the most suitable replacement audit partner is based on industry experience, while matching age and experience levels of the EQCR and engagement partners so that one cannot dominant the other. The more nuanced aspects of audit partner rotation are in matching the personalities of engagement partners to clients. On large client entity audits, audit firms are able to groom

audit partners into the engagement partners role (Dodgson et al. 2020; Pittman et al. 2022), though this may not always work out if their client does not think there is the right chemistry for a relationship to develop. Regulators should understand the industry they are regulating. This research provided qualitative research evidence that audit firms were already rotating audit partners before the regulations were made mandatory.

The difference between Big Four and non-Big Four audit firms is that Big Four audit firms having significantly more audit partner resources changing the dynamic, to matching personalities and being able to provide client entities with a selection of engagement partners to choose from, though they may not be able to provide the most suitable engagement partner due to extended cooling-off periods. Big Four audit firms have an advantage in transitioning audit partners in large client entity audits where there are multiple partners involved. This allows the audit partner to be involved in the audit for potentially a number of years in advance before becoming the engagement partner so that the audit partners can become familiar with the clients' specific matters and form relationships. This effectively counters the lack of knowledge and experience power imbalance that can occur in the first year of an engagement and ensures that the engagement partner can present a robust challenge in auditor negotiations, but negatively impacts the 'fresh perspective' that an engagement partner should impart.

6.2 Contributions to practice

Firstly, this research contributes to practice by identifying how regulations should 'right sized' when transposing regulations from large economies to small economies. Secondly, this research contributes to theory by providing research on how audit firms should develop a matrix to manage audit partner rotation.

6.2.1 Right sizing regulations to an economies GDP and population

The identifiable problem in this research was that New Zealand has transposed audit partner regulations from countries with significant larger GDP's and populations. The implications of this have been that imposed regulations have disproportionately disadvantaged small and mid-tier audit firms that haven't got the audit partner resources to be able to manage the regulations. Audit partners perceived that extended cooling-off periods for engagement partners and EQCR's provide the biggest challenge for audit firms in a small-scale economy.

This research was a qualitative inductive study that has been able to contribute to the theory development of transposing regulations from a large-scale developed economy to small-scaled developed economy (Morgan and Quack, 2006). The purpose of an inductive study is to generate theory (Gasson, 2004). New Zealand regulators initially matched cooling-off periods to the size of the New Zealand audit market then extended them to match regulations imposed on large-scale economies. This has resulted in increased market concentration and certain entity types that are legally required to be audited having trouble gaining the services of audit firms. The theoretical contribution from this research is that imposed regulations need to be 'right sized' to meet the resources available to the audit firms that are operating in the market. By extending cooling-off periods regulators forced some small and mid-tiered audit firms out of the audit market or merge to increase their audit partner resources.

Like most countries New Zealand legally requires certain entity types to be audited. This implies a responsibility on the regulators part to not impede the supply of audit firms providing that service. In implementing regulations, regulators should identify the market participants that are most likely to be affected by the regulations and the sector of the market that those participants supply services too. Analysis should then be performed to determine if

the market is able to absorb the excess demand without imposing significant cost increase on entities that have been affected by the regulations.

6.2.2 Implementing a matrix for audit partner rotation management

This research discovered that audit firms use a matrix to manage audit partner rotation. Because this was new to research the researcher matched the matrix of audit partner rotation to human resource management to provide literature on how organisations incorporate matrixes for employee management. Combining human resource management with the qualitative research evidence in this research allows the researcher to develop a theory on how audit firms could manage a complex multi-dimensional structure of audit partner rotation.

The first step in constructing a matrix for audit partner is to create a computer model for all of regulations that have been put in place. For New Zealand audit firms this would include a three-tiered system for time-on periods followed by five-year cooling-off periods. Time-on periods and cooling-off periods for EQCR's and other key audit partner would be the next step in generating a computer model. The roles that are required by each entity types should then be incorporated into the matrix as well as the industry experience and specialist skills of each audit partner as well as audit managers and team members with specialist knowledge. Age and years of experience in specific industries will allow the correct matching of audit partners and EQCR's.

The purpose of matrix is so that the audit firm can maintain institutional knowledge within the engagement. Audit partner discussed expanding the matrix to cover audit managers but not team members. Incorporating audit managers into the matrix will allow an audit firms to increase the knowledge of client specific matters into the engagement. Based

on industry experience the matrix should identify potential candidates for replacing engagement partners when they are required to rotate.

This research provided qualitative evidence that audit firms profile the personality type of their clients so that they can match the engagement partner to the client. The matrix should contain personality type data on both clients and engagement partners to achieve business chemistry in the auditor client relationship and so that the engagement partner can challenge management on their assumptions and gain favourable outcomes (Beattie et al. 2004). The matrix should also provide the most suitable EQCR's based on personalities, age, and experience so that they can provide a suitable challenge to the engagement partner and audit team.

6.3 Future research

Two future research projects were identified in thesis from discussions with audit partners. The first was mandatory audit firm rotation which can be considered a natural progression from audit partner rotation. The second study is designed to establish if engagement partners are completing their engagements and whether gender influences.

6.3.1 Mandatory audit firm rotation

The topic of mandatory audit firm rotation was a constant theme throughout this research. Some audit partners perceived that its implementation was inevitable in New Zealand and that mandatory audit firm rotation posed a threat to audit. Interviewee 4, Big4 stated that the first audit a company does for a client entity is the hardest. Prior research done on the subject of mandatory audit partner rotation has been mainly quantitative using proxies for audit quality and based on the assumptions that audit partner rotation is a stand-alone event. The results from quantitative prior research have not provided definitive results. This research Dodgson et al. (2020) and Pittman et al. (2022) provide evidence that the reason no

definitive results have been gained from quantitative research is because audit partner rotation is not a stand-alone event but managed by the audit firm. Mandatory audit firm rotation be considered a stand-alone event. Prior research has found that the long tenure of audit firms is associated to increased audit quality (Jackson et al. 2008). Capital market actors such as banks and insurance companies associate long tenure to financial reporting accuracy and credibility (Ball et al. 2008). This indicates that if the regulatory framework progresses towards mandatory audit firm rotation the result could be a decrease in audit quality.

Four audit partners in this research volunteered to help with future research into mandatory audit firm rotation. This would be a mixed methods study that uses qualitative semi-structure interviews with audit partners to determine the correct proxies to use in a quantitative study. Audit partners indicated that the proxies to use for audit firm rotation were the impairment of intangibles measured against information's contained in the cash flow statement. The purpose of this study would be to determine if earnings quality has been affected by changing the audit firm.

In 2016 audit tendering was made mandatory in the UK for FTSE 350 entities (FRC, 2014). Between 2013 and 2016 a hundred and twenty-two FTSE 350 entities put there audits out for tender (Agnew, 2016). Which FTSE 350 entities have changed audit firms since 2016 is publicly available information through the FTSE index and the entities annual report, which provides a sample for this research. The approach to this research could be to emulate the research done by Myers et al. (2003) and Carey and Simnet (2006) using descriptive statistics, regression analysis, and a modified Jones Model.

6.3.3 The implications of gender on audit engagement completions

Audit partner in this research provided qualitative research evidence that there is often significant change amongst directors, managers and staff members of the client entity they are auditing as well as audit team members. That employees are changing employers more

regularly is backed up by the US department of statistics and prior research establishing a five-year career itch. That employee no longer spend as long with employers has been attributed to a generational change from Generation X to Millennials (Martic, 2023). The 2018 working life survey reported that 38% of employees had been with there current employer for more than five-years in New Zealand (StatsNZ).

Audit partner rotation regulation in New Zealand range from five to seven-years for time-on periods. This research and the generational change raises a number of questions: “Are engagement partner on average completing their time-on engagement periods?” And “how long are engagement partners on average spending in engagements”. Research done by Carey and Simnet (2006) and Chai and Huang (2005) provide research evidence that the optimal time-on periods for engagement partners is seven-years. Initially like the UK, New Zealand, Australia, US, and Canada implemented audit partner rotation regulations at five-year time-on periods for its listed entities. In 2010 Canada reversed its five-year time-on periods and implemented seven-year time-on periods for engagement partners auditing listed entities (Daugherty et al. 2012).

Similar to New Zealand audit reports in Canada contains the independent engagement partner’s name. The proposed sample for this research are Toronto Stock Exchange (TSX) entities because of Canada’s seven-year time-on periods. The increased time-on periods will allow the researcher to provide research evidence on whether engagement partners are more likely to complete five or seven-year engagements. This research project could also provide gender specific information such as: What percentage of male and female engagement partners audit TSX entities? Does gender impact the number of years the engagement partner spends in the engagement? and are males or females more likely to complete time-on periods?

Chin and Chi, (2008) Gold et al. (2009) and Ittonen and Pen, (2012) identified sex as an individual characteristic worthy of examination. Landivar (2015) research found that females work fewer hours than their spouses. While Slone (2017) provides research evidence that females are more committed to state employment. What is being proposed is a quantitative research study that uses descriptive statistics to provide quantitative research evidence on average time-on periods for female and male engagements partners using the annual reports of TSX entities.

6.4 Limitations

A critical question in a qualitative research project is whether saturation has been reached. The researcher did not consider that saturation had been reached but did find that participants near the end of this research project were generally providing views that had already been expressed by other participants. The sample for this research was taken from the New Zealand Auditors Register limiting the study to licensed auditors. This excluded a significant number of auditors from this study including auditors that may have left the licensed audit regime due to overregulation.

Taking the sample from the New Zealand's Auditor Register limited the sample to 172 licenced audit partners 28 of which resided in Australia and 1 was located in Singapore. From this sample 13 interviews were conducted consisting of fifteen interviewees, a participation rate 8.72% or 10.48% if audit partners from Australia and Singapore were removed. No audit partners from Australia or Singapore took part in the research limiting the study to perspectives from New Zealand audit partners that resided and were employed within New Zealand. The researcher sent out 26 follow up emails to participants that didn't respond to the first email that was sent, this did not result in any further participants taking part in the research.

This study failed to gain a demographic mix of participants. Only one female took part in the research and most participant ages were between forty-five to sixty. What this meant was that all participants in this study apart from two had experienced the self-regulated environment, followed by the implementation of a state regulatory regime including audit partner rotation. The implication of this is that certain biases may have been exhibited through this study from participants that had experienced both regimes.

This research was subject to financial, word count, and time limitations. The time and word count limitations restricted the researcher from being able to explore the research in full. The financial constraints impacted the amount of travel that the researcher could undertake.

This thesis is for a master's degree in accounting, a theoretical framework is not a requirement for master's degree. Consequently, this research lacked conceptualisation in its research design and research questions (Grant and Osanloo, 2016) connections to the literature review (Rocco and Plankhotnik, 2009) and viewing the data through a theoretical lens (Collins et al. 2018). With additional time and resources, the researcher could have used sociology to gain a greater understanding of the social relationships and interactions that were described by audit partner between, clients, and audit team members (Pentland, 1993).

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Appendices

Appendix 1: Initial contact email to participants – email template

Subject: Invitation to Participate in Audit Partner Rotation Research

Dear [Recipient],

My name is Adam Fairburn, I am currently completing a Master's thesis at the University of Canterbury in Auditing.

This email is an invitation for you to participate in my research, which is focused on the imposition of '*mandatory audit partner rotation regulation*' for the audits of certain entities in New Zealand. The purpose of this research is to give audit partners an opportunity to share their experiences and perspectives on this topic. I am interested to discover how audit firms have responded to the rotation requirements and determine the nature of the regulation's impacts.

As you will be aware, mandatory audit partner rotation regulations have been introduced in many countries, and several studies have identified that their introduction has had significant consequences for audit partners professionally, and in their personal lives. The impacts of these policies are of considerable interest to a range of stakeholders, including regulators, policy makers, shareholders, and others. Ultimately, this research seeks to communicate the opinions of New Zealand audit partners to regulators and other interested parties by way of an academic journal article and to contribute to the international debate surrounding this topic.

Participation in this project will involve an interview discussing your experiences about the aforementioned regulation. The interview will take approximately one hour and can be conducted either face-to-face or via Zoom, at a time and place that is convenient to you. All information provided will be considered completely confidential and your anonymity will be

assured. For further information about this research and procedures for ensuring confidentiality the following documents are attached:

- Consent form
- Information sheet for participants
- Interview protocol

If you agree to participate in this research project, I would be grateful if you could fill in the attached consent form and return a scanned copy to Adam Fairburn at adam.fairburn@pg.canterbury.ac.nz before the [two weeks from the date the email was sent]. I will contact you shortly thereafter to arrange an interview.

Alternatively, if you do not wish to participate, please respond “No” to this email and you will be removed from the mailing list.

Should you have further questions, please feel free to contact me.

Thank you for your time and I look forward to hearing your reply.

Kind Regards

Adam Fairburn

Appendix 2: Interview Protocols

Interview protocols

What I am looking to hear from you in this interview, is your lived experiences and what you observed happening to colleagues and other audit partners throughout this process of change.

1. Please describe your experiences of audit partner rotation(s)? What had happened? Please describe this process.
2. How did the above rotation(s) affect your relationships with clients?

3. From your audit firm perspective what changes have you observed taking place following the introduction of audit partner rotation? What steps have management taken to ensure that audit quality and good client relationships have been maintained?
4. From an industry perspective what changes have you observed taking place following the introduction of audit partner rotation? What steps have management taken to ensure that audit quality and good client relationships have been maintained?
5. How do you evaluate whether audit partner rotation policies have achieved their objective(s)?
6. Are there any implications of mandatory audit partner rotation that you had not anticipated until you have experienced the rotation yourself? Please describe
7. The introduction of the FMA in New Zealand can be said to have reduced the number of domestically registered audit companies. How would you evaluate this statement? What do you think might be the reason?
8. How do you relate audit partner rotation policies to audit quality you have described?
9. Do you feel like audit partner rotation policies are suitable in their current form? What recommendations would you make to regulatory bodies regarding their suitability and the appropriateness of timeframes?
10. Before we conclude this interview, is there anything else you would like to add