

Extended Abstract

The Effect of Auditor Tenure on Audit Quality

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Introduction

High-profile corporate failures that occurred at the beginning of this century have raised concern about the reliability of companies' financial statements. While the primary responsibility for preparing accurate financial statements rests with company management and boards, questions also have been raised about the quality and independence of external auditors. Regulators and standard setters have attempted to enhance audit quality through rules impacting on auditor independence (For example, the Sarbanes-Oxley Act of 2002)

One factor the regulators are concerned that may impair auditor's independence is long auditor tenure (the length of the auditor – client relationship). Their concern is that as the auditor tenure gets longer, auditors are more likely to compromise on their client's accounting and reporting choices in order to retain the client. Mandatory rotation of audit firms for a particular audit client is suggested as a means of improving audit quality through maintained independence and new “fresh eyes” on audits. However, the accounting profession has strongly resisted mandatory audit firm rotation, with potentially high costs of transition being provided as the prominent reason. The proponents of mandatory auditor rotation thus argue that setting a limit on the period of years an audit firm may audit a particular company's financial statements will improve auditor independence and audit quality. The opponents, however, argue that as auditors gain more experience from auditing the

same company over time, they have better knowledge to determine whether the company's accounting and reporting choices are proper. Their argument suggests an improvement in audit quality as the length of auditor tenure increases .

Following DeAngelo (1981) we define audit quality as the market-assessed joint probability that an auditor will discover a breach in a client's accounting system, and conditional on discovery, report the breach .An important consideration in DeAngelo's definition is the market-assessed probabilities, that is, it hinges on the market's perception as to whether a given auditor will perform the audit competently and the perceived degree of auditor independence. On the other hand, the actual audit quality improves the reliability of financial information by reducing the noise contained in financial statements. Although the perceived auditor independence and competence may be positively correlated with actual auditor independence and competence, they are not necessarily the same. This study only examines levels of actual audit quality .

Research Questions or hypothesis

The main objective of this study is the investigation of the effect of auditor tenure on audit quality in firms listed in Tehran stock exchange . Therefore, we formulate the two following hypothesis:

Hypothesis 1: Auditor tenure affects current accruals.

Hypothesis 2: Auditor tenure affects discretionary accruals.

Methods

Following Myers et al (1981) we use Discretionary and Current Accruals as proxies for audit quality:

Current Accruals $_{i,t}(\Delta)$ = $CA_{i,t} - CASH_{i,t} - (CL_{i,t} - STD_{i,t})$ (and

Discretionary Accruals $_{i,t} = Accruals_{i,t} - \beta + .\beta\Delta_{i,t} Revenue_{i,t} + \beta_{i,t} PPE_{i,t}$

where:

$\Delta CA_{i,t}$: change in current assets Δ ; $CASH_{i,t}$: change in cash and cash equivalents Δ ; $CL_{i,t}$: change in current liabilities Δ ; $STD_{i,t}$: change in

short-term notes and current portion of long-term debt; β_i : coefficient estimates from an OLS regression by firm-year; Accruals_{i,t}: operating income-cash flow from operations Δ ; Revenue_{i,t}: change in net sales revenue; and PPE_{i,t}: property, plant, and equipment-net. We scale all variables by beginning book value of total assets.

For test hypothesis, We use the following regression:

$$\text{Accruals}_{i,t} = \alpha + \beta_1 \text{Tenure}_{i,t} + \beta_2 \text{Size}_{i,t} + \beta_3 \text{Age}_{i,t} + \beta_4 \text{SCFO}_{i,t} + \varepsilon_{i,t}$$

where:

Accruals_{i,t}: Discretionary Accruals or Current Accruals; Tenure: the number of consecutive years that the firm has retained the auditor) We measure auditor tenure as of 1997; (Age: the number of years for which total assets was reported; Size: the log of total assets; and SFCO: the firm's cash flow from operations divided by beginning book value of total assets .

In this research, data of 72 companies are analyzed for the period of 2010-2003 on panel data basis and by using of the system of pooled regressions.

Results

Multivariate results, controlling for firm age, size, cash flows, indicate that auditor tenure has no significant effect on audit quality. Therefore, research hypothesis isn't confirmed.

Discussion and Conclusion

While mandatory audit firm rotation is still under debate, prior studies have investigated the relation between audit firm tenure and audit quality. Most of studies find no evidence supporting the argument that audit quality decreases with audit firm tenure. Consistent with these studies, we find that auditor tenure has no significant effect on audit quality.

Given this result, there are minimal, if any, benefits of imposing mandatory audit firm rotation onto Iranian firms. Further, given the costs involved in switching auditor, it does not appear that mandatory audit firm rotation would be beneficial to the market. In order to address the

concerns that have arisen around auditor independence and audit quality, other initiatives are more likely to have a greater impact than imposing mandatory audit firm rotation .

We note that as our sample consists of only Iranian companies during a time period when periodic audit firm rotation is not mandatory, our result may not generalize to the setting in other countries or other setting that require periodic audit firm rotation.

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