

# A Study on the Relation between Auditor Rotation and Audit Quality in Iranian Firms

Bitra Mashayekhi, Marjan Fayyazi, Parisa Sefati

**Abstract**—Audit quality is a popular topic in accounting and auditing research because recent decades' financial crises reduce the reliability of financial reports to public investors and cause significant doubt about the audit profession. Therefore, doing research to identify effective factors in improving audit quality is necessary for bringing back public investors' trust to financial statements as well as audit reports. In this study, we explore the relationship between audit rotation and audit quality. For this purpose, we employ the Duff (2009) model of audit quality to measure audit quality and use a questionnaire survey of 27 audit service quality attributes. Our results show that there is a negative relationship between auditor's rotation and audit quality as we consider the auditor's reputation, capability, assurance, experience, and responsiveness as surrogates for audit quality. There is no evidence for verifying a same relationship when we use the auditor's independence and expertise for measuring audit quality.

**Keywords**—Audit quality, auditor's rotation, reputation, capability, assurance, experience, responsiveness, independence, expertise.

## I. INTRODUCTION

FOLLOWING financial crises and some popular companies' financial scandals during recent two decades, external auditors and the quality of their works has been under question. Similarly, in Iran, detecting a huge financial fraud among some Iranian public banks in 2011 put audit quality and effectiveness under question [1]. The audit quality which is one of the most important subjects in the auditing profession, has been defined as the auditor being capable of detecting and reporting substantial misstatements existing in the sample being examined during the audit process [2]. As a more precise definition and according to [3],

“the quality of audit services is defined to be the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach”,

which roughly means that audit quality depends on the possibility of discovering a misstatement in a financial statement and reporting that by the auditor [3].

Regarding the above-mentioned crises and scandals, audit quality is still a controversial issue and it is worth to study and do research about. For this reason, finding determinants of

audit quality, and consequently solutions for improving that, is mandatory rotation of auditors.

In accordance with [4], limiting the client-auditor relationship and occasionally mandating a new auditor, leads to improve the auditor's independence and audit quality.

As per [5], the effect of mandatory auditor rotation on audit quality is noticeable because the change of auditor may worsen audit quality for losing those partners who have gained more knowledge from longer familiarity with their clients. Reference [5] states that a new auditor is less well informed about the client and, so, there less possibility to recognize a financial reporting problem; as well it is suggested that one opposite result from changing an auditor comes from them bringing a fresh perspective and which can result in a probable improvement in audit quality. However, in many countries there is no limitations on the length of an audit firm tenure, in spite of imposing limitations on the length of audit partner tenure [5]. But in Iran, according to Article 10 (Note 2) of “*Instruction for Securities Exchange Organization (SEO)'s Trusted Audit Firms*”, audit firms and their partners are not permitted to be external auditors of those registered companies at SEO whom have been their clients for four years. Therefore, in Iran, the length of audit firm tenure is limited to four years and this limitation is imposed on SEO's registered companies.

The purpose of our study is to examine the association between perceptions of audit service quality attributes and auditor rotation in the Iranian context, in which legislation, specifically the *Instruction for SEO's Trusted Audit Firms* (2011), mandates replacement of audit firms every four years.

For this purpose, we employ the Duff [6] model of audit quality to hypothesize and measure audit quality, because of its theoretical properties as an integrated multidimensional model of audit quality [7].

We use a questionnaire survey of 27 audit service quality attributes extracted from the audit service quality literature and according to Iranian audit culture; and 68 responses from finance managers have been analysed.

This paper is organized as follows. Section II reviews literature. Section III develops the hypotheses about the association between audit quality attributes and auditor rotation. Section IV discusses the methodology. And finally, Section V presents the results and conclusions.

## II. LITERATURE REVIEW

The failure of Enron and its auditor, Arthur Andersen, quickly directed regulators worldwide to consider altered mechanisms for improving auditor independence. Legislators,

Bitra Mashayekhi (associate professor) is with the Accounting Department Faculty of Management, University of Tehran, Tehran, Iran (e-mail: mashayekhi@ut.ac.ir).

Marjan Fayyazi (assistant professor) is with the HR Department, Faculty of Management, University of Tehran, Tehran, Iran (e-mail: mfayyazi@ut.ac.ir).

Parisa Sefati is M.S in Accounting from University of Tehran, Tehran, Iran (e-mail: p.sefati@gmail.com).

regulators, and professional organizations around the world have suggested mandatory auditor rotation at both the partner and the firm level as a probable means to reduce client–auditor familiarity and introduce new viewpoints, thus enhancing auditor independence and audit quality [8]. Auditor rotation is the practice of changes in auditors to keep a fresh set of eyes on accounts and to prevent overfamiliarity that could lead to misstatements and misrepresentation in financial records.

According to [4], two key opinions have developed over the years about auditor rotation practice. First, proponents of rotation claim that long-term interactions between auditors and their clients increase the risk of audit failures. As auditors get too close to their clients, they lose their interest in audit approaches, and probably lose their independence and objectivity, and subsequently the audit quality is decreased. A common suggested solution to this problem is to require companies to change their auditors on some fixed schedule. However, the mentioned solution increases the risk of new auditors' lack of knowledge of the client and its business, knowledge that is gained over time.

The study of [9] examined a period of mandatory audit firm rotation (1991–1994) and a subsequent period when rotation was no longer mandatory (1995–2000) in Spain. Comparing the frequency of going-concern opinions in these two periods, they found no evidence that the abandonment of mandatory rotation affected audit quality.

Reference [10] studied mandatory audit firm rotation in South Korea; although they found larger income-increasing accruals during the audit firm's first year of tenure after mandatory rotation, they found no significant results when measuring audit quality upon the issuance of going-concern opinions to financially troubled companies. The study of [11] focused on abnormal accruals (as a measure for earnings quality and a surrogate for earnings quality) since 1975, when mandatory rotation came into force in Italy. They found no significant difference in earnings quality during the replacement audit firm's first year after rotation in comparison to other years. Reference [12] examined earnings management in the years before and after mandatory audit firm rotation in Brazil, Italy, and South Korea, and they found no significant change in earnings management.

### III. HYPOTHESIS DEVELOPMENT

Our study hires the Duff (2009) model of audit quality [6] for hypothesizing and measuring audit quality. As noted earlier, we use this because of its theoretical properties as an integrated multidimensional model of audit quality. Our model consists of nine dimensions within four higher-order factors of competence, independence, relationship and service qualities. Our study also employs 27 individual audit quality features extracted from the audit service quality literature, Iranian audit practice, and interview with audit experts. Similar to [7], these features allow us to hypothesize and measure seven of the nine dimensions in audit quality model, including reputation, capability, assurance, independence, experience, expertise, and responsiveness. As our main hypothesis implies a negative significant relationship between perceptions of audit quality

and auditor rotation, using the seven dimensions of the Duff's (2009) model of audit quality [6], our research hypotheses are classified as follows:

- H1: There is a negative significant relationship between auditor's reputation and auditor rotation.
- H2: There is a negative significant relationship between auditor's capability and auditor rotation.
- H3: There is a negative significant relationship between auditor's assurance and auditor rotation.
- H4: There is a negative significant relationship between auditor's independence and auditor rotation.
- H5: There is a negative significant relationship between auditor's experience and auditor rotation.
- H6: There is a negative significant relationship between auditor's expertise and auditor rotation.
- H7: There is a negative significant relationship between auditor's responsiveness and auditor rotation.

### IV. METHODOLOGY

#### A. The Questionnaire

We design our survey questionnaire using Tailored Design Method [13]. The questionnaire was consisted of two sections, and first one provided respondents with the list of 27 attributes. In the questionnaire, respondents were requested to answer following question:

“Assume that you have been asked to evaluate the audit quality provided by your auditor. Please indicate the extent to which you agree or disagree that each aspect will affect your evaluation of the audit quality provided by your auditor?”

A seven-point Likert-type scale was employed ranging from -3 (strongly disagree that the feature would impact their perceptions of audit quality) to +3 (strongly agree). The order of the 27 attributes was randomized to avoid any potential prejudice or bias resulting from demand characteristics [7].

The second section of the questionnaire belonged to the respondent's demographic. And finally, the following question was asked:

“If your company had to make an auditor appointment decision now, would it prefer to (i) retain the current audit firm or (ii) appoint a new audit firm?”

Answers to this question formed the variable of auditor rotation. The questions about 27 attributes of audit quality are presented in Table I.

#### B. Sample Selection

The survey was administered to the sample of 200 chief finance officers (CFOs) and internal auditors (CIAs) via mail and e-mail to the population of 150 registered companies at SEO. We chose CFOs and CIAs as they consult audit committees in choosing and recommending external auditors. The time of data collection was from September, 2016 to September 2017. Of the 200 CFOs and CIAs whom we sent the questionnaire, 125 responded. Therefore, there is a response rate of 62.5%. Because of the high response rate, non-response bias is not considered a threat to the results

validity.

TABLE I  
AUDIT QUALITY ATTRIBUTES AS PER [6]

Questions About Audit Quality
1 The audit partner and manager have been employed for at least three years.
2 The client has been audited by a same audit firm.
3 The audit partner and manager are expert enough regarding the client's industry.
4 The audit firm has other clients from the same industry.
5 Auditing is performed based on a predetermined time budget.
6 The audit team is working upon a flexible time budget.
7 The audit firm has a staff working strategy on the maximum number of hours per day and per week.
8 There is need for communication between the audit team and the client's managers.
9 Client's reputation is a critical factor in choosing them.
10 Audit cost is the main reason for choosing an audit approach.
11 The audit fee matters to the audit firm.
12 The audit partner and manager make frequent visits to audit teams during conducting the audit.
13 The audit partner and manager have consulting meetings with their team.
14 The audit team uses computers and information technology in their audit work.
15 The audit team employs statistical techniques in their audit work.
16 The audit firm conducts a comprehensive study about the client's internal control system.
17 Conducting an audit is based on estimating the audit risk. (performing risk-based auditing)
18 There is an active audit committee in the client's board of directors.
19 The audit team and client's audit committee meet frequently.
20 The audit team is familiar enough with accounting and auditing standards and comply with them.
21 The audit team complies with auditing standards.
22 The audit team is committed to the audit code of conducts.
23 The audit firm has a specific procedure for evaluating the theoretical and practical knowledge of its personnel.
24 The audit team will consult experts if it is necessary.
25 There are approved procedures for hiring and promotion of audit personnel.
26 The audit firm conducts the required technical training for its personnel.
27 The audit firm is accountable for its professional opinions

To test the validity of our questionnaire, we sent it to some experts and use their comments for improving our instrument. Moreover, for testing the reliability research questionnaire, we employ Cronbach's alpha. As the questionnaire is categorized in seven parts, Table II shows Cronbach's alpha for each category. Because Cronbach's alpha for all categories is between 0.8 and 0.7, we can claim that our questionnaire is internally consistent and the test scores are reliable.

TABLE II  
CRONBACH'S ALPHA

Dimensions of Audit Quality Model	Cronbach's Alpha
Auditor's reputation	0.71
Auditor's capability	0.74
Auditor's assurance	0.73
Auditor's independence	0.80
Auditor's experience	0.78
Auditor's expertise	0.76
Auditor's responsiveness	0.77
The questionnaire as a whole	0.87

## V. RESULTS AND CONCLUSION

To test our hypotheses, we use Spearman correlation coefficient, as it evaluates how well the relationship between two variables can be defined using a monotonic function. The results have been shown in Table III.

TABLE III  
CRONBACH'S ALPHA

Dimensions of Audit Quality Model	Spearman Correlation Coefficient	Significance (P-Value)
Auditor's reputation	-0.606	0.000
Auditor's capability	0.510	0.001
Auditor's assurance	-0.209	0.221
Auditor's independence	-0.595	0.000
Auditor's experience	-0.009	0.008
Auditor's expertise	0.266	0.117
Auditor's responsiveness	-0.443	0.007

According to Table III, there is a significant negative relationship between auditor's reputation, capability, independence, experience, and responsiveness with auditor rotation. However, there is not any significant relationship between auditor's assurance and expertise with auditor rotation. Therefore, our 3<sup>rd</sup> and 6<sup>th</sup> hypotheses are rejected as the others are verified.

As we predicted before, there is a negative and significant relationship between auditor rotation and auditor's reputation. According to our results, we can claim that companies who are using the popular and well-known auditor's services are less interested in changing their auditors. Actually, the reputation of auditors can give a reasonable assurance to stockholders about a qualified audit, and consequently, they do not want to change their auditors. On the other hand, we conclude that auditor rotation does not improve audit quality, which is similar to [9], [10].

According to our second hypothesis, we test the relationship between auditor's rotation and auditor's capabilities. Our results show that as more capable auditors with enough knowledge and expertise in the accounting and auditing area are more preferred by audit clients, changing auditors will decrease audit quality (similar to [9] and [10]). The recent conclusion implies that having longer auditing contracts with clients probably increases auditor capabilities in auditing a same client.

Although in hypothesis 3 we predict a negative relationship between auditor's rotation and auditor's assurance, we cannot verify this relationship as per our statistical tests. Therefore, it can be said that in Iranian companies, more assured auditors do not guarantee not changing in auditors. This result is consistent to [7].

According to our fourth hypothesis, we test the relationship between auditor's rotation and auditor's independence. Our results show a significant negative relation between the auditor's rotation and auditor's independency. This implies that audit clients prefer more independent auditors. Also, audit clients change their auditors as they believe they are not independent enough.

In our fifth hypothesis, we look for a negative relationship

between auditor's rotation and auditor's experience. As per [9] and [10], not to change auditors increase their experiences. On the other hand, audit clients are interested in experienced auditors and do not want to change them.

According to hypothesis 6, we test the relationship between auditor's rotation and auditor's expertise. Our results do not show any significant relation between auditor's rotation and auditor's expertise.

In the last hypothesis, we study about the relationship between auditor's rotation and auditor's responsiveness. As our results show a significant negative relation between auditor's rotation and auditor's responsiveness, this suggests that audit clients prefer more responsive auditors. Also, not changing auditors could be a motivation for being more responsive.

As we use the questionnaire as data gathering instrument in this study, we have to accept the inherent limitation of using the questionnaire in the research design. Also, we did not have enough access to financial experts and their times were limited as well, we could not expand our research more and we had to accept our few received questionnaires for data analysis.

For future studies, we suggest other variables and factors for evaluating audit quality. Also, we suggest other researchers to study auditor retention and the effective factors for predicting that.

#### REFERENCES

- [1] Rezaee, Z. and Davani, Gh. 2013. Does Financial Reporting Fraud Recognize Borders? Evidence from Bank Fraud in Iran. *Journal of Forensic & Investigative Accounting*. Vol. 5, Issue 2. pp: 224-238.
- [2] Vanstraelen, A. 2000. Impact of Renewable Long-Term Audit Mandates on Audit Quality. In: *The European Accounting Review*, vol. 9 No. 3, pp. 419-442.
- [3] DeAngelo, L. E. 1981a. Auditor size and audit quality. *Journal of accounting and economics*, 3(3), 183-199.
- [4] Nashwa, G. 2004. Auditor Rotation and the Quality of Audits. *The CPA Journal*, 74, 22-26.
- [5] Lennox C.S.; Wu, X.; and Zhang, T. 2014. "Does Mandatory Rotation of Audit Partners Improve Audit Quality?". *The Accounting Review*. Vol. 89, No. 5. pp. 1775–1803. DOI: 10.2308/accr-50800 2014.
- [6] Duff, 2009, "Measuring audit Quality in an era of change: An empirical investigation of UK audit market stakeholders in 2002 and 2005", *Managerial Auditing Journal*, Vol. 24, No. 3, pp. 400- 422.
- [7] Butcher, K., Harrison, G., and Ross, P. 2013. Perceptions of Audit Service Quality and Auditor Retention. *International Journal of Auditing*. Volume 17, Issue 1. Pages 54-74. doi:10.1111/j.1099-1123.2012.00457.x.
- [8] Firth, M., Rui, O.M., and Wu. X. 2012. How Do Various Forms of Auditor Rotation Affect Audit Quality? Evidence from China. *The International Journal of Accounting*. 47 109–138. doi:10.1016/j.intacc.2011.12.006.
- [9] Ruiz-Barbadillo, E., N., Gomez-Aguilar, and N. Carrera. 2009. Does mandatory audit firm rotation enhance auditor independence? Evidence from Spain. *Auditing: A Journal of Practice & Theory* 28 (1): 113– 135.
- [10] Kwon, S. Y., Y. D. Lim, and R. Simnett. 2010. Mandatory Audit Firm Rotation and Audit Quality: Evidence from the Korean Audit Market. Working paper, Korea University and University of New South Wales.
- [11] Livne, G., and A. Pettinicchio. 2012. Empirical Evidence on Reporting Quality under Dual Mandatory Rotation Rule. Working paper, Bocconi University.
- [12] Harris, K., and S. Whisenant. 2012. Mandatory Audit Rotation: An International Investigation. Working paper, University of Houston.
- [13] Dillman, D. A. 2000, *Mail and Internet Surveys: The Tailored Design Method*, New York: Wiley.