

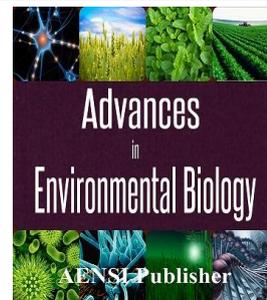


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### The Impact of Reselecting an Auditor on the Auditor Independence and Audit Quality from the Perspective of the Auditors of Audit Office

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#### ABSTRACT

Our purpose of this article is to study the impact of reselecting an auditor on the auditor independence and audit quality from the perspective of auditors of Iran Audit Office. For data collection, we used Likert-scale questionnaire, to perform the calculation process of the data and information needed for this study, and data analysis, we used SPSS software, and to evaluate hypotheses of the research, we used univariate t-tests and Kolmogorov-Smirnov test for normality. The reliability of the questionnaire is achieved based on Cronbach's alpha. According to the results, reselecting an auditor has a significant impact on the auditor independence and by doing that, there will be no long-term relationship between the employer and auditor, and the auditor independence will not be ruined. Moreover, the impact of reselecting auditor on audit quality is confirmed, i.e. by reselecting an auditor, the auditor will gain a more comprehensive understanding of the employer's general system, he or she will understand the employer's specific knowledge better and audit quality will increase consequently.

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#### INTRODUCTION

Due to major fraud in financial reporting of companies such as Tico, GoldQuest, Adlupa and WorldCom, and in recent years in Enron, professional associations of most countries must apply some strategies to prevent such important distortions. In case of such distortions, the first question that comes to users' mind is "where have auditors been?" Transparent and reliable financial information of a comprehensive and appropriate reporting system is considered as the main component of the assessment of the status and performance of a company and decision-making process for trading its securities. Over the years, people with academic education as well as workers or employees have some discussions and debates on the advantages and disadvantages of long-term relationship between auditor and employer. Some of them believe the length of the relationship between an audit firm and customer may jeopardize general mindset in relation to auditor independence and audit quality. There are two viewpoints on auditor rotation and audit quality: the first one is legislators and public's opinion in relation to the reselection of the auditors, they believe a long-term relationship between firms and auditors cause an intimacy and it is harmful for the auditor independence and it reduces audit quality. [15]

Contrary to the first viewpoint, the second viewpoint belongs to members of the accounting and auditing profession and is about auditing problems in the early years of the relationship between auditor and employer. Lack of detailed familiarity with issues like the kind of operations, accounting systems and internal control structure of the related company, increase audit costs and the auditor's fundamental errors and irregularities may not be discovered. In recent years, the phenomenon of rotation of audit firms has become an important area of research and professional issues in most countries. In these countries, there are specific workgroups to study this phenomenon and the effect of applying this process from different perspectives.

##### Research background and literature:

There are two viewpoints on auditor rotation:

Advocates of periodic auditor rotation often use three reasons to justify their viewpoints:

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*Relationship and getting too close to management and the loss of independence:*

Barbadillo and Egoular (2002) studied the impacts of auditor tenure on the phenomenon of sale reporting (sale comment) and they concluded average length of audit contract of companies with sale reporting is few. Whenever tenure is short, auditors try harder to refuse any disagreement with employer in order to recycle venture they used to know their employer. Hence, in the early years of work, their independence is fewer.

The nature of the audit requires a daily communication between auditor and management of the company. A long-term relationship between employer and auditor may cause an intimacy. Due to this intimacy, the auditor may neglect disagreement of audit or even it may cause collusion between the auditor and management of the employer.

*Lack of conservatism in accounting and lack of attention to details due to a monotonous job:*

Regarding the relationship between auditor tenure and conservatism, some people believe when tenure increases, conservatism decreases. They believe in the early years of auditors' work for their new employers, due to the fear of the lawsuits against them following the lack of sufficient knowledge of the business activities, auditors may demand more conservative practices from their bosses. By increase of relationships and probably by decrease of independence, they have no tendency to resist the demands of the management, hereby managers feel optimistic about reporting.

Reselecting auditors may make audit profession a repetitive and monotonous job to auditors. This increases auditors' professional capability. Shockley (1982) believes continuation of auditor selection may cause overconfidence, lack of innovation, and reduction of usages of careful and precise methods among auditors. Moreover, he believes managements and employees will be familiar with the auditor's personal and professional characteristics through a long-term interaction with him or her, they can use it to cheat. Arel, *et al* [15] believe when auditors go back to their previous job, they often rely on the previous worksheets for operations like audit planning, budgeting and providing the information needed for the current audit. This over-reliance on the last year documents, and predicting results rather than paying attention to small but important changes, may prevent them from achieving the objectives of audit.

*Tendency to maintain employer:*

Gietzman and Sen (2003) believe that when auditors receive high fees from their employers, they have more tendencies to extend their contracts with the same employer; it indicates the auditor's desire to maintain independency. They proved if there are few big employers in the market, mandatory rotation might be a favorable political tool, because the possibility of re-appointment of auditors by a big employer is ambiguous and employers will be worry whether they can renew their contracts or not. Hence, the risk of collusion with the management increases and mandatory rotation can fix this problem.

DeAngelo [28] believes to maintain investment in specific knowledge of customer that will be achieved gradually and over a multi-year collaboration with the client, auditors try for retention. In this respect, they may have economic incentives to not to disclose fundamental violations and mistakes. Consequently, these incentives may lessen the auditor independence over years.

*Viewpoint of opponents of mandatory audit rotation:*

These opponents often use four reasons to justify their viewpoint:

*Restricting fundamental knowledge, experience and expertise in the industry:*

Studies indicate fundamental knowledge and experience is vital to offer high quality audit, and they increase over time. Obviously, mandatory audit firm rotation prevents auditors from gathering such basic knowledge and experience and this causes a reverse impact on audit quality. When an auditor knows the company he or she is working in very well, he or she will understand its matters and changes better. Due to the great complexity in the last century in the business environment of firms, auditors could not be familiar with activities of firms in a short time. Current auditors can use their learning curve effect in order to discover basic errors and irregularities, while a new auditor due to lack of sufficient understanding of the firm has to rely on management statements and estimates. Hence, this increases audit risk. Other researchers such as Stais (1991) and Walker, *et al* (2001) concluded most of the shortcomings of audit happen in the early years of the auditor-employer relationship, because the auditor does not have sufficient knowledge about their relationship. Simnett (2004) indicated about 79% of independent audit firms and publicly traded companies of the United States believe due to lack of knowledge of auditors about the firms in the early years of their relationship with their bosses, audit risk increases.

*Increase in audit costs:*

The necessity of periodic auditor rotation will increase direct and indirect audit costs. Simnett (2004) indicated all of major independent audit firms believe due to auditors' need to gain basic knowledge in relation

to the new employer and the type of operation, audit costs of the first year after the periodic rotation of the audit firm, will be 20% more than audit costs in the subsequent years of the employer-auditor relationship.

Arrunada and Pasares (1997) also believe in the first year of work, based on audit standards, an auditor has some tasks such as understanding his or her employer's audit system, the current audit method, reviewing accounts that have remained unchanged for several years, monitoring the inventories, reviewing the financial status of the firm and providing a permanent audit file. These actions increase audit costs.

Hamilton *et al* (2005) believe understanding the business environment, internal controls and financial reporting policies require some prices that normally are only in the first year of an auditor's work.

#### *It weakens the role of audit committee:*

Mandatory audit firm rotation may weaken the role of audit committee. According to Sarbanes - Oxley act, audit committee are now responsible for overseeing the financial reporting process, and hiring and firing independent auditors. Mandatory audit firm rotation will prevent audit committee from selecting and maintaining the most qualified audit firm for applying audit tasks. Audit committee is responsible for selecting and observing audit firms. Hence, it should use its discernment and judgment ability to determine the most appropriate audit firm for the audit tasks of the firm. Audit committee considers different factors such as tenure of the audit firm for doing that. Other important factors for audit committee are competence and credibility of the audit firm, experience of the institute in the relevant industry and rationality of its audit program. It seems audit committee is perfect for assessing audit quality and determining auditor independence and objectivity. It is obvious audit committee considers re-employment of audit firm as a good decision. Mandatory audit firm rotation prevent audit committee from selecting or reselecting an audit firm and providing the highest qualitative audit with the most efficient and effective method. It gets worse when the firm acts in a specialized industry and audit institutes have little knowledge about them, and when the firm is located in a specific geographic location, and there are few available audit institutes for giving audit services. [4]

#### *Deformation of competition among audit firms:*

In the economy based on the free market, firms are more excited for investment, because when firms are able to increase their customers, it leads to profitability. The necessity of periodic audit rotation makes audit institutes lose a customer after the end of a specific period and they will not be able to give service to this customer for years. Due to this, those institutes that have had a larger share of the market have to leave their customer gradually and those institutes that have had less share of the market will have more opportunities to attract customers. Predictably, due to this process, after some periods of rotation, periodic audit rotation equalizes the market share of audit firms in giving audit services. Because of this equalization, audit institutes instead of timely investments, delay their market share until its final confirmation. In fact, due to the necessity of periodic audit rotation, institutes with high performance cannot receive their award for being good, because these rules lessen demands for their services gradually. On the other hand, institutes with low performance not only will not suffer loss but also may meet increase in their customers. Hence, we can say, in a system that insists on periodic auditor rotations, incentives for improving performance decrease. In this case, in a long run, some rules equalize the market share of audit firms and they lessen the incentives of these institutions for compete and by preventing competition between audit institutions, they decrease audit performance indirectly.

Moreover, periodic auditor rotation provides a circumstance for shaping some secret, illegal agreements between firms for exchanging customers after the completion of the maximum period permitted by law. Decrease in risk of losing customer and investments for gaining the specific knowledge, may encourage audit institutions to create such agreements, so they can return to give services to their previous customers when the legal period ends. Such agreements lead to the creation of oligopoly in the market for audit services.

#### *Research background:*

##### *Foreign studies:*

Copley and Daket (1993) studied the relationship between auditor tenure and audit quality. According to their results, increase in the length of auditor-employer relationship leads to increase in audit quality. However, a very long-term relationship lessens audit quality. They recommended periodic rotation for increasing audit quality.

According to the research results of Arrunada and Pas-ares (1997), and Arrunada (2000), mandatory audit rotation due to its high costs for auditors and employers, cannot be a proper tool for improving auditor independence and audit quality.

Dopuch *et al* (2001) concluded mandatory audit rotation decreases the auditor's tendency to publish desired audit reports of the management and it increases the auditor independence.

According to Dopuch *et al* (2001), Wu-Chun *et al* (2002), and Hussey and Lan (2007), mandatory audit rotation ruins auditor independence instead of improving it.

Johnson *et al* (2002) concluded a short-term relationship between auditor and employer decreases the quality of financial reports.

Carcello and Nugei (2004) studied the relationship between audit quality and firms rotation in terms of financial reporting. Given their results, there is a direct relationship between the length of a short-term audit and the number of reports with important distortions. Generally, important distortions happen in the early years of audit, hence, in such circumstances, audit firms rotation has a negative impact on audit quality.

Arrunada and Ares (2005) studied the impact of audit firm rotation on audit quality. According to the results, there is a direct relationship between the auditor-employer relationship and auditors' competence. Afterwards, they studied auditor independence regarding fee, relationship with employer, the remaining contract value of firms and potential contract fee. Given their results, audit firm rotation cannot increase the possibility of auditors' search.

Moreover, their research indicates a new auditor's conservatism during the early years of his or her work is relatively low. Finally, they found a positive relationship between the length of the auditor-employer relationship and conservatism in earnings reporting.

Dan Li (2010) has a research regarding the length of auditor-employer relationship and its relation with conservative reporting and he concludes this relation is positive in big firms and companies with extreme control from auditor. However, in small companies and companies without extreme control, the relation is negative.

Sati *et al* (2014) have a research named "mandatory rotation of audit partner" and they conclude the rule of mandatory auditor rotation increased audit quality of Chinese companies for three years.

Belen *et al* (2014) have a research named "auditor tenure and audit quality" and they realized with an increase in auditor tenure, audit quality improves and this improvement continues for five years and after the fifth year, it lessens.

#### *Domestic studies:*

Rajabi (2008) in his research called "rotation of audit firms and its impact on audit quality of the listed companies in the Tehran Stock Exchange" looked for the answer of the following question, "Does audit firm rotation increase audit quality?"

In this regard, the researcher studied some detecting factors for distortions in the financial statements (auditor's competence) and the report of the distortions (auditor's independence) and concluded audit firm rotation does not increase audit quality.

Karami and Bazrafshan (2009) studied the relationship between auditor tenure and conservative earnings report in the Tehran Stock Exchange. Given the results, there is a significant, positive relationship between auditor tenure and conservatism. Generally, in short tenure, conservatism is lesser. Hence, it is possible that mandatory auditor rotation has a reverse impact on conservative earnings.

Hasas Yeganeh (2010) in his research named "studying the impact of mandatory audit firm on audit quality of the listed companies in the Tehran Stock Exchange" concluded the rotation of audit firms does not increase the audit quality of the listed companies in the Tehran Stock Exchange. Karami (2010) in his research named "the consequences of auditor rotation" realized probably the best solution is rotation of audit partners and staff instead of rotation of audit firms. In this regard, auditor independence will remain untouched and audit costs will not increase a lot.

## MATERIALS AND METHODS

#### *Research hypotheses:*

In order to achieve the research objectives and answer the main research question, main hypotheses are as follows:

1. Reselecting the auditor has a significant impact on the auditor independence.
2. Reselecting the auditor has a significant impact on audit quality.

#### *Research validity and reliability:*

It is important to have items with validity and reliability for a research, because they indicate the acceptability and accuracy of social studies.

For this research, we referred to professionals and experts for the validity of the research questionnaire and to design it, we shared comments. In this regard, before preliminary testing, we offered our suggested questionnaire, the theoretical framework and the research hypotheses to professors and experts and we considered their viewpoints in the questionnaire of the preliminary test.

We used Cronbach's alpha in order to assess the reliability of the research-measuring tool. The general formula of Cronbach's alpha is as follows. K is number of questions,  $\sigma_{Y_i}^2$  is variance of each question and  $\sigma_X^2$  is total variance of the questions.

$$\alpha = \frac{K}{K-1} \left( 1 - \frac{\sum_{i=1}^K \sigma_{Y_i}^2}{\sigma_X^2} \right)$$

It is said, when the alpha coefficient is more than 70%=0.7, the test has acceptable reliability. The results of the reliability are in the table below.

**Table 5:** the reliability of the questionnaire

| Variable             | Number of items | Cronbach's alpha |
|----------------------|-----------------|------------------|
| Auditor independence | 10              | 0.718            |
| Audit quality        | 10              | 0.7              |
| Total                | 20              | 0.804            |

Given the above table, the alpha of the total questionnaire is 0.804 and it is more than 0.7, hence, the questionnaire is valid. In other words, if we distribute the questionnaire one more time, we will get the same results.

*The first hypothesis:*

reselecting the auditor has an impact on the auditor independence.

Null hypothesis and the first hypothesis for the above hypothesis testing are as follows.

H: reselecting the auditor does not have a significant impact on the auditor independence.

H<sub>1</sub>: reselecting the auditor has a significant impact on the auditor independence.

The first ten questions of the questionnaire are for the hypothesis testing, we estimated the mean of these ten variables in order to obtain the distance variable, now we use univariate t-test that is as follows.

In order to have a more accurate univariate t-test, it is better to have variables with normal distribution.

Since our sample includes 230 individuals, the appropriate test is Kolmogorov-Smirnov normality test. The hypotheses of this test and the output of Statistical Packages for Social Sciences (SPSS) are as follows.

H: the variable is normal.

H<sub>1</sub>: the variable is not normal.

|                      | Kolmogorov-Smirnov |     |       |
|----------------------|--------------------|-----|-------|
|                      | Statistic          | DF  | Sig.  |
| Auditor independence | 0.044              | 229 | .200  |
| Audit quality        | 0.039              | 229 | 0.200 |

Since in this test, the significance level (sig.) is 0.2 and more than 0.05, the null hypothesis regarding normality is accepted.

*The output of SPSS of t-test of the first hypothesis:*

| Variable   | Mean of population | Mean of sample | T-statistic | Degree of freedom | Significance level | The confirmed hypothesis                                   |
|--|--------------------|----------------|-------------|-------------------|--------------------|--|
| The impact of re-selecting the auditor on the auditor independence | 3                  | 3.36           | 9.68        | 228               | .000               | H <sub>0</sub> is rejected and H <sub>1</sub> is accepted. |

Given the above table and the significance level, that is zero and less than type I error 0.05, we conclude the null hypothesis is rejected and the second hypothesis that is the mean of population and sample is accepted. Since the mean of sample is 3.36 and the mean of population is 3, we conclude the mean of sample is more than the mean of population and since this difference is significant, we realize from the perspective of the respondents, reselecting the auditor has a significant impact on the auditor independence.

*The second hypothesis:*

reselecting the auditor has a significant impact on the audit quality.

The null hypothesis and the first hypothesis for the above hypothesis testing are as follows.

H: reselecting the auditor does not have a significant impact on audit quality.

H<sub>1</sub>: reselecting the auditor has a significant impact on audit quality.

The second ten questions of the questionnaire are for this hypothesis testing, we estimate the mean of these ten variables in order to obtain the distance variable, now we use univariate t-test one more time.

*The output of SPSS of the t-test of the second hypothesis:*

| Variable  | Mean of population | Mean of sample | T-statistic | Degree of freedom | Significance level | The confirmed hypothesis                                   |
|---|--------------------|----------------|-------------|-------------------|--------------------|--|
| The impact of re-selecting the auditor on audit quality | 3                  | 3.35           | 10.35       | 229               | 000                | H <sub>0</sub> is rejected and H <sub>1</sub> is accepted. |

Given the above results and significance level, that is zero and less than type I error 0.05, we conclude the null hypothesis is rejected and the second hypothesis that is the mean of population and sample is accepted. Since the mean of sample is 3.36 and the mean of population is 3, we realize the mean of sample is more than the mean of population and since this difference is significant, we conclude from the perspective of the respondents, reselecting the auditor has a significant impact on audit quality.

#### Conclusion and recommendations:

After financial scandals of companies such as Enron and WorldCom, the subject of auditor rotation as a means to improve auditor independence and audit quality has become one the most important debates of governments and national agencies like America Society of Certified Public Accountants and Securities and Exchange Commission. Sarbanes - Oxley act and the decisions of the United States Securities and Exchange Commission emphasize auditor rotation. America Society of Certified Public Accountants believes applying this is not enough for improving audit quality and is disagree with it. However, accounting supervision board of publicly traded companies emphasized doing rotation on its instruction in 2011. In Iran, regular audit firm rotation during a 4-year period has been approved based on the instructions of trusted audit firms of Stock Exchange on August 8, 2007. Given what we mentioned earlier, in this paper, we studied the impact of reselecting the auditor on the auditor independence and audit quality. The significant impact of both of them is confirmed. In the first hypothesis that is about the impact of reselecting the auditor on independence, if we reselect the auditor, there will be no long-term relationship between the auditor and his or her employer, and the independency will not be ruined. According to Lenox (1984), Myers *et al* (2003), Dopuch *et al* (2001), Wu-Chun *et al* (2002), and Hussey and Lan, in case of auditor rotation, the independency will be ruined.

Regarding the impact of reselecting an auditor on audit quality, we concluded by reselecting the auditor, the auditor will give a more comprehensive understanding of his or her employer's general system and he or she will understand the employer's specific knowledge better and following that, audit quality will increase. Some studies by Copley *et al* (1993) and Arrunada *et al* (2005) indicated reselecting the auditor increases audit quality. According to Belin *et al* (2014) increase in tenure, improves audit quality for five years. Some studies by Johnson *et al* (2002), Rajabi (2008) and Hasas Yeganeh (2010) show auditor rotation will not increase audit quality.

According to the research results, using comprehensive evaluation method of the audit firm function by audit committee instead of the rule of audit firm rotation is recommended.

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