



Audit firm tenure and qualified opinions: New evidence from Spain[☆]

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ABSTRACT

The 2010 Green Paper on Audit Policy by the European Commission has explicitly questioned the sufficiency of audit rotation rules established by European Union Members to guarantee auditor independence. In addition, the Paper clearly states that more research is needed regarding the effects of long audit tenures on independence. In this article, we have replicated the research by Ruiz-Barbadillo, Gómez-Aguilar, and Biedma (2005) about the effects of audit firm tenure on independence with more updated data. However, unlike them, we have performed panel data estimations instead of pooled regression. Our approach allows for a better control of individual unobserved heterogeneity, thus reducing potential problems caused by omitted variable bias. While Ruiz-Barbadillo et al. reported an unexpected positive effect of tenure on the likelihood of audit qualifications, we do not show any significant effect of tenure on the opinion of the audit report. Our results are robust to various sensitivity analyses.

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Efecto de la duración del contrato de auditoría en la recepción de informes cualificados: nueva evidencia para el mercado español

RESUMEN

El Libro Verde sobre Política de Auditoría elaborado por la Comisión Europea en 2010 ha puesto en duda la suficiencia del marco regulatorio actual de la auditoría vigente en la Unión Europea para garantizar adecuadamente la independencia del auditor. Además, el documento reconoce explícitamente la necesidad de más investigación sobre los efectos en la independencia del auditor de relaciones de auditoría que se perpetúan en el tiempo. En este artículo, hemos replicado, con datos más actuales, la investigación de Ruiz-Barbadillo et al. Sin embargo, a diferencia de ellos, hemos utilizado un enfoque de datos de panel en lugar de una regresión agrupada. Nuestra aproximación permite controlar mejor los problemas derivados de la heterogeneidad no observada, reduciendo los problemas de sesgo debido a la omisión de variables. Ruiz-Barbadillo et al. obtuvieron el resultado inesperado que a mayor número de años auditados por un mismo auditor más probable era que el informe de auditoría presentara salvedades. Nuestros resultados, por el contrario, no muestran ningún efecto significativo de la duración de la relación con el auditor en la opinión del informe de auditoría. Los resultados obtenidos son robustos a los análisis de sensibilidad que se han realizado.

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Introduction

The growing importance of corporate governance matters for researchers and policy makers, particularly after the dot-com

bubble and more recently the contemporaneous financial crisis, has motivated a large body of research on the quality of financial statements. The proliferation of corporate scandals as Enron, WorldCom, Parmalat and Lehman Brothers have posed serious concerns about the reliability of financial statements, since in none of these cases they showed the real situation of the firm.

The external auditor is the key figure to guarantee the quality of financial statements, and thus its role is crucial in the corporate governance scheme. When these statements have an unqualified opinion, participants in the financial markets assume they show the current situation of the firm. Nevertheless, the external auditor

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faces a conflict of interests regarding the relationship with the audited company that may undermine its credibility when judging its clients' financial statements. The Sarbanes-Oxley Act (SOX), passed largely as a reaction to corporate financial scandals of the dot-com era, attempted to improve the quality of financial statements of public companies in the U.S. Among other issues, the SOX included some provisions to strengthen auditor independence. With the same aim, corporate governance codes approved in numerous countries worldwide have included recommendations to guarantee auditor independence.

The length of auditor-client relationships constitutes a major issue in the auditor conflict of interest, because long relationships may cause auditor complacency about management decisions regarding the firm's financial statements. Following this view, the mandatory rotation of external auditors has long been suggested to improve independence. With this aim, the SOX required a study about the potential effects of imposing mandatory rotation. Although the results of the study did not support that auditor rotation increased the quality of financial reports, and therefore, it did not recommend mandatory rotation (Myers, Myers, & Omer, 2003), regulators finally established that lead audit partners and concurring partners could not perform audit services for the same client for more than five consecutive fiscal years. In addition, they also required a minimum five-year time-out period before a partner might return to audit a client. Similarly to the situation in the U.S., mandatory rotation of the audit partner is nowadays required in many countries.

The Green Paper on Audit Policy, (EC, 2010) by the European Commission, explicitly questions the sufficiency of the actual regulatory framework to guarantee auditor independence. The Paper also encourages additional research about the effects of long audit tenures on independence. In this line, the main motivation of this article is to provide new and updated evidence about the effects of audit tenure on independence. Besides, available research for low litigation risk countries following our approach is not only scarce (Ruiz-Barbadillo, Gómez-Aguilar, & Biedma, 2005; Vanstraelen, 2000) but also provides conflicting results. It should also be noted that both articles analyze the audit sector before the fall of Arthur-Andersen and the enforcement of the SOX. During the last decade, not only the audit sector has been subjected to important regulatory changes, but also, litigation risk seems to have increased even in low litigation risk countries. Therefore, as posed among others authors by Fargher and Jiang (2008) and Feldmann and Read (2010), results reported by previous research need to be updated.

This paper makes several contributions to the literature. Firstly and most importantly, the methodology we propose is robust compared with both Vanstraelen (2000) and Ruiz-Barbadillo et al. (2005) (hereafter RBGB). Despite the panel structure of their data, neither Vanstraelen (2000) nor RBGB used a panel data approach to undertake the analyses. Both papers performed a pooled logistic regression, although they did not mention any test on a likely autocorrelation pattern in their data. The main advantage of panel data estimation over pooled regression is that it allows controlling for individual unobserved heterogeneity. Since unobserved heterogeneity is the main problem in non-experimental research, this advantage becomes particularly useful. In the specific case of the investigation of audit qualifications, given the generally low explanatory power of the proposed models, there is a serious potential for an omitted variable bias, due to unobserved heterogeneity. In addition, unlike both Vanstraelen (2000) and RBGB, significance tests have been performed with robust standard errors. This issue becomes important because, due to the panel structure of the data, the error term will not be independent and identically distributed. Consequently, results reported by Vanstraelen (2000) and RBGB might suffer from methodological pitfalls. Secondly, we report new evidence about the effects of tenure on audit qualifications which

do not support available evidence for the Spanish market. Unlike RBGB, reporting an unexpected strength of independence associated to longer tenures, we do not find a significant effect of tenure on independence. Finally, unlike both Vanstraelen (2000) and RBGB, which did not check the robustness of the reported results, our results are robust to various sensitivity analyses.

The remainder of the paper is organized as follows. In section "Audit regulation in Spain", we outline the regulation of the auditor-client relationship in Spain. In section "Review of the literature" we review previous research. In section "Research design", we develop our model and explain the dataset. In section "Results" are discussed and section "Sensitivity analyses" are presented in section six. Finally, in section "Conclusion", we summarize the main conclusions.

Audit regulation in Spain

The market for audit services in Spain started with the implementation of the 8th Directive on Company Law. With the main goal of increasing the reliability of the company's financial statements the Spanish Audit Law was enforced in 1988. The Law established the obligation for companies above a certain size to appoint an external auditor to issue a report about the company's financial statements. A change in the legislation in 1997 increased the minimum size for a company to be obliged to audit financial statements, and reduced approximately by a 20% the number of companies subject to audit (García-Benau, Ruiz-Barbadillo, Humphrey, & Husaini, 1999).

To safeguard auditor independence, the Spanish Audit Law established a set of criteria to regulate the auditor-client relationship. Accordingly, a multi-year contract was established with a length ranging between three and nine years. In addition, independently of the length of the initial contract, the re-election of the audit firm was not allowed. The imposition of a limit in the number of years a company could be audited by the same firm was equivalent to establish a mandatory auditor rotation rule. Nevertheless, both, the limit on the maximum number of years to be audited by the same firm, and the prohibition to renew the audit contract were abolished after a legal reform in 1995. Afterwards, auditors would be contracted for an initial period ranging between three and nine years, but after the expiration of the initial contract the company could renew the contract with the auditor on a yearly basis. A consensus exists that Spanish legislation has not been particularly strict in specifying safeguards to strengthen auditor independence (Gonzalo, 1995; Paz-Ares, 1996; Ruiz-Barbadillo, Gómez-Aguilar, De Fuentes-Barberá, & García-Benau, 2004). Although, from a legal point of view a company could break its audit contract only if a 'just cause' exists, given that the Law did not clarify what this just cause could be, a company could hire and fire its auditor without any time limitation (Gómez-Aguilar & Ruiz-Barbadillo, 2000).

Similarly to the SOX in the U.S., the Spanish Financial Law was enforced in 2002 as a reaction to corporate financial scandals. During the process of approving the Law, an amendment was included containing the mandatory rotation of the audit firm every twelve years. According to this amendment, the external auditor would be hired for an initial period of three years and could be renewed for periods of three years, with a maximum of twelve years. After the expiration of this term, the change of the audit firm would be mandatory, and a minimum three-year period was required to re-hire the audit firm. This amendment elicited strong criticism from the auditing profession (Ruiz-Barbadillo, Gómez-Aguilar, & Carrera, 2006), which finally led to its withdrawal. At the end of the process, mandatory rotation was limited to change the audit team but not the audit firm.

Following the revised 8th Directive, the 27 member states of the European Union were required to adapt their national law systems.

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