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Audit Firm Tenure and Audit Quality in a Constrained Market

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ABSTRACT

We examine the relation between audit quality and audit firm tenure in the Iranian audit market, which is constrained by government policies that create intense competition for clients among many small audit firms. We develop arguments that these circumstances create cost pressures that entrench low audit quality and render auditors' plans more predictable to managers wishing to misstate their accounts. Using publicly available data for the audits of listed companies in Iran prior to mandatory audit firm rotation and the incidence of misstated financial reports identified by the Iranian Association of Certified Public Accountants Inspection Office, we find that the likelihood of a misstatement is lowest in the first two years of audit firm tenure. We also find that the likelihood of misstatement is not associated with the year preceding a mandatory audit firm rotation, suggesting outgoing auditor effort is not sensitive to the prospect of subsequent revelations of deficiencies. Although our results from a pre-mandatory rotation period show that frequent rotations appear to improve the financial reporting quality in our sample, we are wary of interpreting these results as support for the mandatory audit firm rotation policy in Iran. Rather, we suggest this is a peculiar consequence of deficiencies in audit quality inherent in the Iranian market.

1. Introduction

This paper examines the relation between audit firm tenure and audit quality in the Iranian audit market. The effect of audit firm tenure on audit quality, and thus on the quality of financial reports, has been the subject of a long debate among professionals and regulators. Regulators around the world have considered mechanisms aimed to improve auditor independence, including mandatory auditor rotation at both the partner and firm level (Firth, Rui, & Wu, 2012).

Proponents of mandatory audit firm rotation emphasize the auditor independence hypothesis to argue that audit quality tends to decline with audit firm tenure because longer tenure can increase economic dependency on the client (DeAngelo, 1981; Raghunathan, Lewis, & Evans, 1994), induce auditor complacency (AICPA, 1992; GAO, 2003; Johnson, Khurana, & Reynolds, 2002; Shockley, 1981), and increase familiarity threats to auditor independence (AICPA, 1992; Arel, Brody, & Pany, 2005). By limiting tenure, mandatory audit firm rotation can reduce the likelihood of economic dependency, familiarity, and complacency (Mautz & Sharaf, 1961).

Opponents of mandatory audit firm rotation refer to economic bonding arising from fee dependence to argue against mandatory rotation. To the extent that auditors low-ball audit fees (DeAngelo, 1981), audit firms are more likely to accede to their clients'

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demands in the initial years of tenure for fear of threats of dismissal and loss of future quasi-rents(Geiger & Raghunandan, 2002). Thus, as audit firms earn those quasi-rents with increase in tenure, they are more likely not to acquiesce to clients' demands in the later years of tenure, which may tend to increased audit quality (Arel etal., 2005). Also, it is argued that audit quality tends to increase with audit firm tenure because the auditor gains a better understanding of the client's systems, internal controls, business, and industry environment (Beck, Frecka, & Solomon, 1988; Geiger & Raghunandan, 2002).

However, both sides of the audit firm rotation debate are predicated on assumptions regarding institutions and market conditions that attach substantial value to auditor independence and competence. These assumptions might not hold for immature audit markets where supply and demand conditions do not encourage or facilitate auditor independence, auditor competence, audit effort, or auditors' investments in improving audit quality. Low investments in training, licensing, and oversight of auditors; the absence of sufficiently strong market mechanisms that reward or punish differences in audit quality; and limited audit firm resources may result in low levels of auditor independence or otherwise impede audit quality regardless of audit firm tenure.

We examine these concerns using data from the Iranian audit market, which has functioned in its current form for < 20 years. The potential weaknesses of audits in an underdeveloped market may also be exacerbated in the absence of beneficial spill-overs from international audit firms and networks. The Iranian market is a constrained market characterized by auditors' very limited exposure to legal sanctions, regulations that exclude international accounting firms, and intense competition among many small firms (see Azizkhani, 2012; Bagherpour, Monroe, & Shailer, 2014). Auditor competition in the Iranian market is strongly price based, which adversely affects audit firms' finances (Bozorg Asl, 2012) and their capacity to employ experienced staff and invest in risk-based audit technologies (Safar, Bayati, Arjomanndi, SareRaz, & Nikookar, 2013). Competition among private auditors for private-sector clients is also concentrated by restricting the audits of state-owned entities (where government ownership exceeds 50%) to the Iranian Audit Organization (IAO). Our interest in the Iranian audit market is also motivated by the introduction of mandatory audit firm rotations for listed companies every four years, commencing in 2011.[1] Because this short rotation horizon may compound the negative consequences for audit quality associated with financially constrained audit firms, we examine audit quality in relation to audit firm tenure prior to the introduction of the mandatory rotation policy, using misstatements in financial reports that were identified through the inspection process of the Iranian Association of Certified Public Accountants (IACPA). The IACPA inspections identify cases where the auditor failed to detect or report material misstatement.[2] Misstatements are used in prior studies as a measure of audit quality (e.g.,Bishop, Hermanson, & Houston, 2013; Church & Shefchik, 2012; Hermanson, Houston, & Rice, 2007; Hribar, Kravet, & Wilson, 2014) and are considered superior to other measures because they do not suffer from measurement errors associated with other proxies (DeFond & Zhang, 2014). We also argue that using misstatements identified by systematic investigations by the regulator avoids the problem of unrevealed misstatements that might otherwise exist in markets with weak audit functions.[3]

Proponents of mandatory audit firm rotation argue that audit quality can be improved by rotation because the incoming audit firm provides a fresh perspective to the audit (Chi, Huang, Liao, & Xie, 2009). However, the Iranian audit market has deficiencies in auditor training, is denied spillover benefits from international accounting firms, lacks evidence of domestic demand for high-quality audits, and has intense price competition among auditors that discourages investment in audit technologies and skilled, experienced senior auditors. These factors have contributed to a general absence of risk analysis in audit planning, with almost all private audit firms continuing to use standardized systems-based auditing approaches (Safar etal., 2013). This reliance on standardized systems-based audits results in audit firms applying routine audit programs with little or no modification across clients or from year to year. Consequently, a manager wishing to manipulate financial reports might soon identify the auditor's methods and tests and avoid predictable forms or areas of scrutiny. Therefore, we expect that a manipulative manager is most constrained when the audit is least predictable, which is likely to be the first year or two of an audit firm's tenure, before managers observe the auditor's standard audit program.

Using publicly available data for the audits of listed companies in Iran prior to mandatory audit firm rotation and using the incidence of misstated financial reports identified through the inspection process of the IACPA, we find that, consistent with our argument, the likelihood of a misstatement is lowest in the first two years of the audit firm tenure. We also find that the likelihood of misstatement is not lower in the year preceding a mandatory audit firm rotation, which suggests that outgoing audit firms are not motivated to invest in higher audit effort or quality, and that the audit firm does not strongly associate future prospects or their market reputation with revealed audit quality. We do not suggest that these results provide any support for the mandatory audit firm rotation policy in Iran. Rather, we suggest they are indicative of more fundamental audit quality deficiencies that are inherent in the Iranian market.

This study contributes to the literature in at least two ways. First, we develop arguments pertaining to the relation between audit quality and tenure that have not been previously canvassed in the literature, and which we contend are more important in emerging markets in jurisdictions with weak institutions than in more developed markets. Second, we examine the relation between audit firm tenure and financial statement quality in a market that is constrained by policies that exclude international audit firms and discourage practitioners from investing in audit quality. In combination, these contributions may open broader debates about audit firm

[1] Among jurisdictions that require audit firm rotation, short rotation periods seem more evident in less developed markets, with mandated periods of five years in Brazil since 1999 and China since 2010, and six years in Korea since 2003. The European Parliament approved mandatory audit firm rotation every ten years for EU-listed companies in 2014.

[2] The IACPA's inspection process also identifies audits where the auditor failed to collect sufficient evidence to support an audit opinion; however, these cases are not reported as misstated financial reports.

[3] We are grateful to an anonymous referee for drawing our attention to this advantage of our misstatement measure.

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