

Mandatory Audit Rotation and Audit Opinion in Firms Listed in Tehran Stock Exchange

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Abstract

The regulations require firms to disclose the reasons of changing auditors. Periodic audit rotation of firms indicates importance of this issue for users of accounting information. Audit rotation is important with respect to two viewpoints of mandatory and voluntary rotation. The present research is intended to study the factors affecting mandatory audit rotation and audit opinion, and its mutual effects on each other. To do so, 244 auditors of firms listed in Tehran StockExchange were randomly selected to complete the researcher-made questionnaire. The results indicate that there is a significant positive relationship between increased auditor's fees, risk, firm size and mandatoryauditrotation. Also, there is a positive significant relationship between type of audit reporting and changing of the auditors.

Keywords: Mandatory Audit Rotation, Audit Opinion, Tehran Stock Exchange.

quality through maintained independence and new 'fresh eyes' on audits independence (Li, 2010).

Audit rotation was firstly mandated in Italian listed firms in 1974. Italy currently has a statutory requirement for audit firm rotation every nine years, and Austria recently approved a law that requires audit firm rotation by the end of every six years. In 1989, Spain adopted legislation mandating audit firm rotation by the end of nine years, but the legislation was repealed in 1997, one year before it would have had a practical effect. Greece requires audit firm rotation every six years for public sector entities, and beginning in March 2002 the Singaporean central bank has required that banks incorporated in Singapore change their audit firms at least every five years (Zeff, 2003). However, regulatory bodies in Iran have just mandated audit rotation after 3 years of firms auditing. This is while Sarbanes-Oxley act of 2002 section 203 mandated audit rotation after 5 years of firms auditing.

According to Kaplan and Mauldin (2008), threats to auditor independence may stem from sociological or economic pressures. Under economic theory, audit firms have economic motivations to hold an ongoing relationship with an audit client for obtaining profits from future audits. When the audit firm anticipates an ongoing future relationship the audit firm may audit with less scrutiny and go along with aggressive accounting methods to protect their stream of quasi-rents which jeopardize their independence (Watts and Zimmerman, 1986). Mandating audit firm rotation mitigates this hazard. Under a sociological perspective, Moore *et al.* (2006) describe how clients express gradual pressures to encourage their self-satisfaction among practitioners in the case that auditors will be more likely to divert their conclusions.

Introduction

Several audit failures (e.g., Enron, WorldCom, Sunbeam, and Waste Management) have raised concerns internationally about auditor's independence, audit quality, and the need for regulatory actions (Firth *et al.*, 2012). In an effort to improve audit quality in the US capital markets, the Sarbanes-Oxley Act of 2002 (SOX) instituted numerous changes that impact the structure of the audit market and the quality of audit services (DeFond and Lennox, 2011). Regulators and standard-setters have attempted to enhance audit quality through rules affecting auditor. Mandatory rotation of audit firms for a particular audit client is suggested as a mean of improving audit

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On the other hand, some scholars argue that new auditors have no acquaintance with business activities and internal control systems of audit and rely on management decisions about financial reporting so there is a possibility of allowing opportunistic behaviour of managers. The principal argument for mandatory rotation of the audit firm is that it would contribute to enhanced auditor independence vis-a-vis the client company, and the principal argument raised against mandatory rotation is the higher cost and the substantial risks confronting the audit firm during the initial year of an audit engagement (Zeff, 2003).

Furthermore, Arel *et al.* (2006) argue that auditors in the rotation condition are more likely to modify their audit report as contrasted to those in a situation in which a continuing relationship is expected.

However, taking these issues into consideration, the aim of this study is to investigate the factors affecting mandatory audit rotation and audit opinion and its mutual effects on each other.

Conceptual Framework and Literature Review

In general, there are many factors that affect audit rotation that can be classified in two categories:

1. Factors related to auditors and audit.
2. Factors related to auditee.

According to DeAngelo (1981) factors related to auditee and audit are firms size, financial leverage and board composition, and factors related to auditors are audit fee, audit opinion and audit quality.

Factors Related to Auditors and Audit

Audit Opinion

Managers are intended to prevent auditors from expressing non-unqualified opinions because of audit opinions impact on stock market price and its impact on management compensation. However, it is expected that non-unqualified opinions results in audit rotation.

Audit Type (Audit Quality)

According to Sajadi *et al.* (2007) audit firms type have an impact on non-unqualified audit opinion.

Factors Related to Auditee

Firm's Growth

Firms with respect to their growth need verity of audit and non-audit services. Growing firms are more intended to change their auditors (Rajabi, 2006).

Profitability

Increase in firms profitability results in auditors change. Firms with low profit are more likely to receive non-unqualified audit opinion which leads to audit change (Setayesh and Jamalpourian, 2009).

Financial Leverage

Financial leverage of a firms show its ability to fulfill its long term obligations which is an important factor in investigation of firms going concern by auditors. However, firms with more financial leverage are more likely to change their auditors (Rezazadeh and Kamal, 2007).

Corporate Governance

Change in top management of a firm may affect audit change that may result from new management tendency to work with his or her previous auditors (Rajabi, 2006). Lin *et al.* (2009) with investigation of the relationship between corporate governance and audit rotation find that firms with low quality of corporate governance are more likely to hire small audit firms and for this reason change their auditors.

Earnings Management

Earnings management opportunity is a threshold for presence of conflict between auditors and firms managers which present potentials for audit changes (Rajabi, 2006).

Firm's Size

Bigger firms are more intended to have a good supervision of owners on managers. However, big firms are more likely to have good audit quality (Rajabi, 2006).

Passing the law of audit rotation in many countries sparked the motivation to investigate about audit rotation and its consequences, some of which are mentioned as below.

Ding and Jia (2012) surveyed the relationships between auditor mergers, audit quality and audit fees. By measuring audit quality by earnings quality of clients they show that in the post-merger period, absolute discretionary accruals of big-X client firms decreased compared with non-big-X client firms, indicating less earnings management. In addition, they indicate that in the post-merger period, earnings of big-X clients are more related to stock-market returns, indicating that earnings quality has improved in this period. They do not find such changes for non-big-X client firms.

Daniels and Booker (2011) surveyed the effects of audit firm rotation on perceived auditor independence and audit quality and indicate that loan officers do perceive an increase in independence when the company follows an audit firm rotation policy. However, the length of auditor tenure within rotation fails to significantly change loan officers' perceptions of independence. Moreover, their findings also indicate that neither the presence of a rotation policy nor the length of the auditor tenure within rotation significantly influences the loan officers' perceptions of audit quality.

Lu and Sivaramakrishnan (2009) in a research titled 'Mandatory audit firm rotation' indicate that when firms are looking for auditors according to their appetite, mandatory audit firm rotation increases investment efficiency in these firms.

Houghton and Jubb (1999) found a significant and positive association between the presence of an audit qualification and significantly higher fees paid. This relationship holds both in the case of an audit qualification contemporaneous with the fee charged, and of one occurring in the year preceding the disclosed fee(s). However, the effect on audit fees occurs only on a lagged opinion basis, while the

effect on NAS fees occurs only on a concurrent opinion basis.

Stanley and DeZoort (2007) investigated as to audit firm tenure and financial restatements. Their results support prior findings by indicating a negative relation between the length of the auditor-client relationship and the likelihood of restatement. They find that auditor industry specialization and audit fees are negatively related to the likelihood of restatement. Alternatively, the long tenure results indicate an insignificant relation between non-audit fees and the likelihood of restatement. This finding contradicts independence concerns about non-audit fees paid to entrenched auditors.

Daniels and Booker (2011) investigated as to the effects of audit firm rotation on perceived auditor independence and audit quality. Their findings gathering 212 responses indicate that loan officers do perceive an increase in independence when the company follows an audit firm rotation policy. However, the length of auditor tenure within rotation fails to significantly change loan officers' perceptions of independence. Their findings also indicate that neither the presence of a rotation policy nor the length of the auditor tenure within rotation significantly influences the loan officers' perception of audit quality.

Hypotheses Development

There is a significant relationship between audit fee and mandatory audit rotation.

There is a significant relationship between firm's risk and mandatory audit rotation.

There is a significant relationship between firm's size and mandatory audit rotation.

There is a significant relationship between audit fee and audit opinion.

There is a significant relationship between firm's size and audit opinion.

There is a significant relationship between firm's risk and audit opinion.

There is a significant relationship between mandatory audit rotation and audit opinion.

Methodology and Data Collection

The present study is an applied research since it aims to find effective factors on mandatory audit rotation and audit opinion. Since the study uses researcher-made questionnaire to collect necessity data for hypotheses analyses, it can be considered as survey study.

The statistical population of the study includes all firms listed in TSE during 2006 to 2009. However, to obtain a homogenous sample, following conditions are considered in sampling:

1. investment firms and banks are excluded from sample.
2. firms with fiscal year other than end of solar year and those that have changed their fiscal year are omitted from sample.
3. Finally in accessible firms are ignored in sampling.

Table 1: Effective factors on mandatory audit rotate and audit report type

	Dimensions	Questions quantity
Effective factors on mandatory audit rotate	Audit fee	4
	Firms risk	4
	Firms size	4
Effective factors on audit report type	Audit fee	4
	Firms risk	4
	Firms size	4

Considering these conditions, a sample of 96 firms is selected and 244 of their auditors completed the questionnaires. The questionnaire was developed in 7 categories for capturing effective factors on mandatory audit rotate and audit report type as shown in Table 1.

Empirical Results

The results of hypotheses test are shown in Table 2.

The results of Table 2 indicate that all of the hypotheses are accepted in 99 percent confidence level which means audit fee, firm's risk and firm's size affect audit rotation, and audit fee, firm's size, firms risk and audit rotation have a positive impact on audit opinion.

Discussion and Conclusion

The current research is aimed to study the factors affecting mandatory changing of the auditor and audit opinion and their mutual effects on each other. To do so, 244 auditors of the firms listed in Tehran Stock Exchange were randomly selected to complete the researcher-made questionnaire. In this study seven hypotheses are developed to examine the factors affecting mandatory changing of the auditor and audit opinion and their mutual effects on each other. First hypothesis argues that audit fee affects mandatory audit rotation which is accepted which means high audit fees result in mandatory audit rotation. Second hypothesis supposed that firm's risk have an impact on mandatory audit rotation which is accepted meaning that risky firms have more tendencies to change their auditors. Third hypothesis posits that firm's size affects mandatory audit rotation which is accepted indicating that bigger firms have more tendencies to change their auditors periodically. Bigger firms intended to use big audit firms audit services and so they want high quality of auditing because of absolute separation between management and ownership for supervision purpose of owners. Fourth hypothesis purposes that audit fee affect audit opinion which is accepted showing that audit fee may alter audit opinion.

Table 2: Summary results of hypotheses test

	T	df	Sig	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
					Audit fee and audit rotation	50.746
Firm's risk and audit rotation	26.648	243	.000	.82275	.7619	.8836
Firm's size and audit rotation	31.579	243	.000	.79559	.7460	.8452
Audit fee and audit opinion	29.522	243	.000	.91137	.8506	.9722
Firm's size and audit opinion	25.272	243	.000	.89191	.8224	.9614
Firm's risk and audit opinion	23.705	243	.000	.88217	.8089	.9555
Audit rotation and audit opinion	24.997	243	.000	.87961	.8103	.9489

Fifth hypothesis suggests that firm's size has an impact on audit opinion. This hypothesis is accepted highlighting that auditors change their opinions with respect to firm's size. This may be because of the fact that bigger firms are more subject to scrutiny and if these firms collapse it will have tremendous social consequences bringing a law case for auditors. This result suggests that auditors should be more careful in facing bigger firms to prevent potential consequences. Sixth hypothesis argues that firm's risk has an effect on audit opinion which is accepted. This is logical that auditors of risky firms will consider the risk of firm into consideration in their opinions to prevent themselves from potential consequences as such mentioned in bigger firm's case. Seventh hypothesis manifests that mandatory audit rotation affect audit opinion. This hypothesis, too, is accepted which shows audit rotation cause to audit opinion change. This result is in accordance with that given by Arel *et al.* (2006).

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