



Surveying the Relationship between Auditor's Tenure and Audit Quality with Financial Distress of Governmental Companies

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Abstract: Proper information flow in this market leads to take logical and correct decisions behalf participants and finally, it causes economic development and the improvement of social relations. Auditor's opinion can play significant role to take financial decisions by internal and external users. According to this importance, the research tries to survey the relationship between auditor tenure and audit quality with financial distress in state companies. The results indicate that there is a positive significant relationship between auditor tenure and financial distress. On the other hand, according to the second hypothesis, if auditor tenure increases in companies, financial distress will increase.

Keywords: Auditor Tenure, Audit Quality, Financial Distress

INTRODUCTION

Financial reporting and disclosure of information is two of the important sources of information which its purpose is to provide required information for economic decisions and to supply most of the capital market's informational needs. But what is more important is to provide auditor's opinion about these reports, which can play a significant role in making financial decisions by users inside and outside the organization. Despite identical monitoring mechanisms for auditor's opinion, it seems monitoring mechanisms should be made for these opinions. Higher audit quality can increase the reliability of financial statements, which results in reducing information asymmetry and thereby reducing the cost of new investments attraction. Given the above, the study of audit quality is important. Another intended variable is auditor's tenure. In this case, it should be mentioned that business monitoring organizations consider long-term tenure as a threat for audit quality, because of its negative effects on auditor independence.¹ Accordingly, they seek to limit the length of tenure (at the level of audit firm or audit partners). The main concern in this regard is that increasing the length of auditor tenure results in a decrease in auditor independence; therefore, auditors will be more willing to deal with companies' reporting practices and to accept them. This means that increasing the length of tenure leads to a decrease in audit quality. In general, with regard to the above items and other variables in this study, it is essential to identify the quality of audit

opinions and effective characteristics of auditors in Iran's capital market. This may result in users' true understanding of financial statements, actual quality of reports audited by the auditors, and finally creating a common language for audit quality. According to the internal report of the chairman of the trusted auditors' committee of the Stock Exchange in recent years, it is important to know whether files existed in trusted auditors' committee of the Stock Exchange and primal staff of chartered accountant community indicates that audit opinions should be reviewed based on the characteristics of auditors in Iran. It should be noted that the dissemination of information among different groups provides a minimum level of knowledge and awareness about the financial situation, performance, and flexibility². Therefore, the auditor's opinion has an important role in transparency of financial statements for decision makers.

Theoretical Framework and Research Background

Independent Variable

- **Quality of auditing firm**

Quality of audit report emphasizes on this point that auditors can play significant role in reporting and discovering existing misstatements. This can point out the quality of auditing firm.

Auditor tenure

Auditor tenure is the number of years that an independent auditor works for an auditee. Companies select their auditor according to General Assemblies' approval. Continuation of cooperation of independent auditor and legal inspector is based on interaction between parties. In some cases, it can be seen that continuation of cooperation for several years is different for various firms and industries. It is argued that long term relationship between auditor and auditee may cause auditor's carelessness and negligence in performing the role of his or her attestation³.

Dependent Variable

- **Financial Bankruptcy**

Bankruptcy prediction is done using different methods. Among them, analysis of ratio and analysis of market risk have been received more attention. In analysis of market risk, the possibility of bankruptcy occurrence has been estimated using occurred changes in market risk (such as, systematic risk and variance rate of return of a share). In analysis of ratios method, the possibility of bankruptcy occurrence has been estimated using a set of financial ratios which have been integrated by experts⁴. Altman index has been used to predict bankruptcy in this research.

Financial bankruptcy consists of financial status of company in term of the existence of bankruptcy risk. This risk is defined operationally using Altman' Z model as follows:

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Edward Altman developed Z model in 1968. Then, he removed some problems in this model in later years. This model was called adjusted Z model. This model is a specific model for producing companies and it is used to predict bankruptcy in all producing units including public and private.

Through multiple audit analysis and among 22 financial ratios which he believed they are the best predictors for bankruptcy, he selected mixed 5 ratios as the best predictors of bankruptcy. These 5 mixed ratios consist of:

Current ratio (x1)

Working capital ratio (x2)

Profit ratio prior to interest and tax to all assets (x3)

Book value ratio of equity to debt book value (x4)

Profit ratio prior to interest and tax to sale (x5)

Following models were used by Altman:

$$Z'=0.717X1+0.84X2+3.1X3+0.42X4+0.998X5$$

If Z' is lower than 1.2, it is perfect bankruptcy,

If Z' is lower than 2.9, it is between bankruptcy and non - bankruptcy.

If Z' is bigger than 2.9, business unit is a healthy one.

Research Background

Bae and Choi studied the relationship between auditor's industry specialization and investment efficiency among service companies. Using a large sample of Korean firms during the period of 1976 – 2005, they showed that there is a positive relationship between auditor industry specialization and investment efficiency⁵. Lenard and Yu investigated the relationship between audit quality and investment decisions among audited Chinese companies by The Big Four audit firms. Their results indicate that the ratio of over-capitalization for companies that have longer tenure is low and for companies that have shorter tenure is about 70%. Therefore, investment efficiency is significantly high in firms with longer tenure⁶.

Alastair et al. addressed this issue in Canada that "Whether difference in audit quality indices between big audit firms and non-big firms is related to the characteristics of the auditee unit." They found that there is no significant difference between the effects of big audit firms and non-big audit firms on abnormal accruals of the auditee units⁷.

Bani Mahd and Akbari⁸ surveyed the relationship between 5 variables of Altman's bankruptcy prediction model and auditor turnover in a period of 7 years from 2001 to 2007. Using mixed data from 56 companies indicated that there is not a significant relationship between above variables and auditor turnover.

MATEREAL AND METHOD

Descriptive statistics, including mean, variance, standard deviation, and quartiles were used to define variables. Furthermore, T-test, F-test, and regression were used to test the hypotheses. The default regression tests, such

as normality of data and lack of autocorrelation between variables, etc. also were used. We first performed descriptive data analysis to analyze the given data and then accomplished hypotheses testing. Excel software was used in order to analyze the collected data. Method of "panel data" was used to test the hypotheses.

Research Hypotheses

1. There is a significant relationship between auditor's tenure and financial distress.
2. There is a significant relationship between audit quality and financial distress

RESULTS

Testing Hypotheses

First Hypothesis

1. There is a significant relationship between auditor's tenure and financial distress.

The results of first hypothesis in following table (surveying the significance level of fitted models) show that there is a positive significant relationship between auditor's tenure and financial distress at 5% error level. Hence, it can be expressed H_0 is rejected and H_1 is supported ($sig < 0.05$). These results indicate that if auditor's tenure increases in companies, financial distress will increase. Surveying the determination coefficient of fitted regression models indicate that auditor's tenure can explain 3.5 percent of the changes of financial distress in under – studied companies. On the other hand, because significance level of t-statistics of regression coefficient of auditor's tenure in fitted model is smaller than 5%, then there is a positive significant relationship between auditor's tenure and financial distress at 5% error level. It means that if auditor's tenure changes one unit, financial distress of companies will increase 0.775 units.

Table 1. Testing first hypothesis

Independent variable	Financial distress		
	Slope (B)	t-statistics	Significance level
Intercept	10.067	56.07	0.000
Auditor's tenure	0.775	2.36	0.02
Determination coefficient	0.043		
Adjusted determination coefficient	0.035		
F-statistics	5.570 (0.02)		
Watson – Durbin	1.7		

Second Hypothesis

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1. There is a significant relationship between audit quality and financial distress.

Surveying the determination coefficient of second research hypothesis indicate that audit quality in companies can explain 6.8 percent of financial distress in companies. On the other hand, the results of regression model show that significant level of F-statistics (9.146 & 11.590) is smaller than 5 percent and significant. It implies that there is a negative significant relationship between audit quality and financial distress above the 95% confidence level. Then H_0 is rejected and H_1 is supported. Surveying regression coefficient of audit quality variable in fitted models shows that if audit quality variable changes one unit, financial distress will decrease or change -0.907 units. It means that whatever audit quality in companies increases, financial distress (bankruptcy) will decrease.

Table 2. Testing second hypothesis

Independent variable	Financial distress		
	Slope (B)	t-statistics	Significance level
Intercept	10.685	54.629	0.000
Audit quality	-0.907	-3.024	0.003
Determination coefficient		0.068	
Adjusted determination coefficient		0.061	
F-statistics		9.146 (0.003)	
Watson – Durbin		1.647	

CONCLUSIONS

Auditing is considered as one of the main pillars of accountability process to users, because accountability is required the existence of reliable and valid information and the reliability of information for some reasons should be evaluate by an independent person from provider of information. In accountability process, auditing makes added value through determining information validation. In this process, auditor plays a significant role in assessing financial distress. In this research we consider the effect of audit quality and auditor's tenure with financial distress of state companies.

According to above explanation, the hypotheses of this research consist of as follows:

1. There is a significant relationship between auditors' tenure and financial distress.

According to statistical analysis and the significance level of fitted models, it can be noted that there is a positive significant relationship between auditor's tenure and financial distress at 5% error level. Hence, it can be expressed that H_0 is rejected and H_1 is supported ($\text{sig} < 0.05$). These results show that if auditor's tenure of companies increases, financial distress also will increase. In analysis of this hypothesis, it can be noted that whatever auditor's tenure is smaller in companies and their turnover is more, the possibility of financial distress of companies will increase. According to laws, it is argued that long – term relationship between auditor and owner might to lead carelessness and auditor

fails to attest honestly. Because of this, auditors must have job rotation. The lack of auditor's independence is another important topic that concerns a lot. A recommended solution for removing this problem is mandatory job rotation. Because of this, mandatory job rotation of auditors has been received more attention in legal and law discussions. But it should be noted that mandatory change of auditor damages companies. There are some factors in this relationship that auditors are forced to maintain their independence. For example, auditors' endeavors for maintaining their reputation or fear of potential legal claims are the mechanisms which prevent auditors' improper behaviors. During the time, auditors gain better understanding and more experiences from owner's activities. So their abilities increase about proper or improper accounting procedures and financial reporting. Then long - term relationship between auditor and owner can increase audit quality and save the companies from bankruptcy.

2. There is a significant relationship between audit quality and financial distress.

According to statistical analysis of this hypothesis, it can be stated that audit quality can determine 6.8 percent of financial distress. On the other hand, the significance results of regression model show that significance level of F-statistics is smaller than 5% and significant. It means that there is a negative significant relationship between audit quality and financial distress at higher 95% confidence level.

In analysis of this hypothesis, it can be stated that audit quality consists of auditor's goodwill and career cares. In result, auditor's reputation increase the quality of financial statements. In other words, audit quality is the increase of auditor's capability towards discovering accounting misstatements and the assessment of auditor's independence and skill by market. According to the result, whatever audit quality increases, financial distress of companies will decrease and it can save companies from bankruptcy.

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