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Auditor Rotation and Legal, Tax and Accounting Distortions

Javad Galini*, Mohammad Reza Abdoli
Department of Accounting, Shahrood Branch, Islamic Azad University, Shahrood, Iran.

A B S T R A C T

Awareness of the reliability of financial information is very important for reasons such as conflict of interests, economic events complexity and so on. On the other hand, financial scandals of large corporates like Enron and WorldCom caused the issue of using the services of independent auditors, precise monitoring, noticing audit reports quality and maintaining the independence of audit institutions to be seriously considered. Therefore, to increase the quality of audit reports and to maintain the independence of audit institutions various strategies have been provided by the professional bodies and experts in this field. One of the recommendations they offered is regular rotation of the audit firm. In recent years, the change (rotation) of the auditors in listed corporates in Stock Exchange has become a conventional phenomenon. This can affect the auditor's professional power and independence and cause unfavorable consequences. The auditor rotation influences the audit profession performance and its credibility on the one hand and on the other hand on the flow of capital in the financial markets. The present study aims to examine the relationship between the auditor rotation and legal, tax and accounting distortions in corporates. The sample of the study consisted of 130 corporates listed in Tehran Stock Exchange for the 5-year period of 2009 to 2013. To verify the research hypotheses, multiple regression test has been used. Statistical Hypotheses have been evaluated using control variables of audit quality, auditor's opinion and firm size. The results of hypotheses testing show that the rotation of auditors will lead to reduce distortions such as tax, legal and accounting distortions. The results also indicate that the increase in audit quality and firm size decreases corporates' auditor rotation.

Keywords: Auditor rotation, Legal distortions, Tax distortions, Accounting distortions, Audit quality.

INTRODUCTION

There is a variety of reasons for changing the auditor, including the desire to reduce the fee for the audit, enhance annual reports credibility, improve audit quality, reduce agency costs, and achieve the desired opinion and so on. Financial scandals of great corporates like Enron and WorldCom etc. revealed the need for improving practical ways of corporate governance and accounting transparency. Presence of major shareholders, the composition of the Board of Directors (executive board members) and presence of internal auditor are the important measures of corporate governance. Among these cases, the purchase of the auditor's opinion has been noticed the most, because by which the management decides to replace the auditor that will

*Corresponding Author: galinijavad@yahoo.com

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accept the accounting data and financial reports with many violations. Research has also shown that, depending on the dissatisfaction of the auditor's report and auditor's opinion purchase, auditor rotation is a significant and main concern of investors, regulators and researchers(Tu, 2012). On the other hand, in some cases, despite of receiving a favorable opinion, corporates have begun to change auditors (Tu, 2012) that it must be due to factors beyond the auditor's performance. The purpose of this research is to find a scientific answer to the question that whether there is a significant relationship between the auditor rotation and legal, tax and accounting distortions in corporates. In other words, the present study seeks to find the answer to this question that whether auditor rotation is influential on legal, tax and accounting distortions. In the case of impact, change in which one has more impact?

LITERATURE REVIEW

Khodayar-e-Yeganeh, Kangarlouei, and Motavassel (2012), studied the impact of audit firms' change on the quality of the audit report. Audit quality audit is sum of competence (the ability to detect mistakes) and auditor independence (motivation for reporting discovered cases) for 167 corporates from 2006 to 2008. The results obtained from collected data analysis suggest that audit firms' change will not lead to audit quality increase.

Bazrafshan, Karami, and Mohammadi (2011), in a study examined the relationship between auditor tenure (auditor rotation) and earnings management in 133 listed corporates in Tehran Stock Exchange during the period from 2000 to 2006. The results showed that with the increase of auditor tenure and auditor lack of rotation, management flexibility in using discretionary accruals will increase and managers will apply the earnings management for negative purposes. Therefore, long-term relationship between the client and the auditor and the lack of auditor change will increase management flexibility in using discretionary accruals. However, they will be used to reduce (conservative) income.

Kashanipour, Meranjouri, and SM (2012), examined the relationship of auditor tenure and auditor change with discretionary accruals. The study population was corporates listed on the Stock Exchange. Based on the considered conditions for sample selection, 260 corporates-years were chosen during the period from 2006 to 2010. Panel analysis was used to analyze data. The results of the research hypothesis testing showed that there is a significant positive correlation between discretionary accruals and auditor tenure in all corporates surveyed. This means that audit firms change does not result in a decrease in accruals and an increase in audit quality.

Febrianto and Sugiri (2012), on a study entitled "Does auditor mandatory rotation increase audit quality", found that audit quality after rotation is lower than audit quality before rotation. After the rotation, auditor will be more conservative and skeptics over the new employer, because the pressure on discretionary accruals will be more.

Reid and Carcello (2017), in their research investigated the reaction of investors to mandatory rotation of audit viewpoint. Their research results indicate that the market will show a negative reaction to the mandatory rotation viewpoint. If the current auditor is expert in a given industry or is one of the four largest corporates, the market will react negatively. Market reaction will be more negative, if the corporate has high quality audit for abnormal accruals. In addition, if the auditor tenure is longer, the market reaction will be more negative.

Idawati (2014), in a study entitled "Effects of audit rotation, audit fees and auditor qualifications on audit incentives and its application on audit quality", found that there is a significant correlation between audit rotation, audit fees and auditor qualifications. Audit rotation, audit fees and auditor qualifications are simultaneously effective on the audit

incentives. Audit rotation, audit fees, auditor qualifications, and auditor incentives simultaneously affect audit quality.

THEORETICAL BASES AND RESEARCH HYPOTHESES

In recent years, the phenomenon of audit firms' rotation has become an important field of research and professional debate in many countries. For example, Sarbanes Oxley Act by America Congress can be referred to, which improved the independence and quality of audit. The Act requires audit institutions to mandatory rotate responsible partners after 5 years of continuous auditing of a business owner. Auditor rotation in Iran is a phenomenon that has become increasingly popular in the country after the formation of the Society of Certified Public Accountants. Managers of business units are always trying to show performance positively. Therefore, they pay significant attention to auditors' opinion of the financial statements of the business units under their control. Problem begins when managers use a series of procedures that are not consistent with accounting principles and standards. They force the independent auditors to provide a favorable comment about these procedures. This would undermine the independence of the auditors. In Iran, according to Clause 2 of Article 10 of the instructions of trusted audit institutions of Stock Exchange Act of 2007/30/7 audit institutions and audit responsible partners after four years are not allowed to accept again the position of the independent auditor and legal persons inspector that is entitled in the instructions.

In order to achieve the objectives of the research the hypotheses are formulated as follows:

The first hypothesis: Auditors' rotation can lead to legal distortions reduction.

The second hypothesis: Auditors' rotation can lead to tax distortions reduction.

The third hypothesis: Auditors' rotation can lead to accounting distortions reduction.

METHODOLOGY

The research methodology is descriptive correlational and multiple regression method is used to test the hypotheses and to evaluate the effects of variables. The present study is a quasi-experimental or post-event research, which is carried out based on actual stock market data and the financial statements of corporates listed in Tehran Stock Exchange. Since the results obtained can be used in the decision-making process, this research is an applied study.

Dependent Variable:

Auditor Rotation: Auditor rotation is the change of the auditor from Audit Organization to a private audit firm or from a private audit firm to another private audit firm that is member of Society of Certified Public Accountants. If the change happens the value of this variable will be the number one, otherwise it is zero(Prasad & Chand, 2017).

Independent Variable:

Legal Distortions: For the operational definition of legal distortions variable, a dummy variable is used, so that if in the report of the auditor or regulatory inspector, rules non-compliance (legal distortion) is present, the value of one, otherwise zero is considered(Spathis, 2002).

Tax Distortions: Tax distortions refer to non-compliance with tax rules and regulations that are mainly related to tax evaders, concealment of income, etc. The major source of data collection about tax distortions is the corporates' audit reports. Therefore, if audit reports contain provisions on corporate tax distortions, the value of one, otherwise zero is considered(Zopounidis, Doumpos, & Spathis, 2000).

Accounting Distortions: The financial distortions refer to firms deviations from accounting and financial standards. To measure financial distortions taken by the corporate, independent auditor's reports are used. If in the auditor's report, the deviation from accounting

standards is mentioned and due to its importance, the conditional or rejected statement is issued, the value of one, otherwise zero is considered(Spathis, 2002).

Control variables:

Firm Size: is measured by the natural logarithm of total assets(Kuo & Wang, 2015).

Auditor's Opinion: includes the auditor's opinion on the financial statements of the corporate (If auditor opinion has been changed the value of one, otherwise zero is considered) (Köhler, Ratzinger-Sakel, & Theis, 2020).

The research population includes listed corporates in Tehran Stock Exchange for the fiscal years from 2009 to 2013. In order to estimate the sample size and sampling the targeted deletion method is used. In other words, those corporates of the population that have the following conditions have been selected as sample and the rest has been omitted:

1. Corporates activities are ongoing during the financial year.
2. The fiscal year end is March.
3. Corporates are not among investment firms and financial intermediation.
4. Research required information of the corporates is available.

Due to the restrictions imposed, among the number of corporates listed in Tehran Stock Exchange, 130 corporates have been selected as sample using systematic elimination method.

RESULTS

Descriptive review of research variables shows that the mean of accounting distortions is 0.623, the mean of legal distortions is equal to 0.869 and the mean of tax distortions is 0.284. These results suggest that the tax, legal and accounting distortions in most evaluated corporates have taken place. This means that the majority of corporates have legal, tax and accounting distortions. The mean of the dependent variable, the rotation of audit (0.431) shows that the evaluated corporates in this study have small audit rotation.

Table 1. Descriptive Statistics of Research Variables

		Auditor Rotation	Accounting Distortions	Legal Distortions	Tax Distortions
No.	Correct	130	130	130	130
	Wrong	0	0	0	0
Mean		0.4308	0.6231	0.8692	0.2846
Standard Deviation		0.49710	0.48649	0.33845	0.45298
Variance		0.247	0.237	0.115	0.205
Skewness		0.283	-0.514	-2.216	0.966
Skewness Std. Error		0.212	0.212	0.212	0.212
Elongation		-1.950	-1.763	2.956	-1.084
Elongation Std. Error		0.422	0.422	0.422	0.422
Min.		0.00	0.00	0.00	0.00
Max.		1.00	1.00	1.00	1.00

The Results of the First Hypothesis Testing

Table 2. The Results of the First Hypothesis

Variables	Coefficient	Standard Error	Wald Statistics	Significance
Intercept	4.229	1.511	8.099	0.004
Legal Distortions	0.238	0.562	0.179	0.673
Audit Quality	-1.362	0.584	5.439	0.02
Auditor's Opinion	0.195	0.414	0.223	0.637
Firm Size	-0.661	0.242	7.479	0.006
Chi-Square Statistic of Omnibus Test (Significance)			14.65 (0.005)	
Determination Coefficients of Cox - Snell			0.107	
Determination Coefficients of Nagelkerke			0.143	

The results of research first hypothesis summary in table (2) show that determination coefficients of Cox - Snell and Nagelkerke (almost maximum and minimum) are estimated 0.107 and 0.143 percent, respectively. This indicates that approximately 10.7 to 14.3 percent of the changes in the rotation of audit in evaluated corporates are justified by the variables entered into the model. On the other hand, given that the significant level of amount of chi-square statistic (14.65) is obtained less than 5%, the fitted model is significant. That is to say, legal distortions and control variables can predict the rotation of audit in evaluated corporates very well. Therefore, with the confidence level more than 95% H_0 hypothesis is rejected and H_1 hypothesis is accepted.

The review on the regression coefficients of estimated model variable shows that auditor quality (-1.362) and firm size (-0.661) have a significant negative impact on audit rotation at 5% error level (0.05> sig). These results indicate that the more increase in quality of the auditor and the corporate size, the more decrease will be in rotation of audit in the corporates. Finally, with respect to the obtained coefficients the prediction equation can be formulated as follows:

$$Ln = \left(\frac{Audit\ rotation}{Audit\ non-rotation}\right)$$
$$= 4.299 + 0.238\ (Legal\ distortions) - 1.362\ (Audit\ quality)$$
$$+ 0.195\ (Auditor\ opinion) - 0.661\ (Firm\ size)$$

The Classification Table

The review on the results of the classification table show that for the 130 corporates, there are 10 classification errors for corporates without audit rotation and 34 for corporates with audit rotation. According to the table, the sensitivity of the model to determine the corporates without rotation of audit is 86.5 percent and the corporates with auditor rotation is 39.3 percent. In general, the fitted model has correctly classified 66.2 percent of corporates.

Table 3. The Classification Table of the Dependent Variable of Audit Rotation

Auditor Rotation	Prediction		Correct Prediction Percentage
Auditor Rotation	Lack	Have	
Lack	64	10	86.5%
Have	34	22	39.3%
General Correct Prediction Percentage of the Model			66.2%

The Results of the Second Hypothesis Testing

Table 4. The Results of the Second Hypothesis

Variables	Coefficient	Standard Error	Wald Statistics	Significance
Intercept	4.414	1.461	9.125	0.003
Legal Distortions	0.441	0.421	1.098	0.295
Audit Quality	-1.360	0.586	5.386	0.02
Auditor's Opinion	0.229	0.416	0.304	0.581
Firm Size	-0.669	0.242	7.643	0.006
Chi-Square Statistic of Omnibus Test (Significance)			15.57 (0.004)	
Determination Coefficients of Cox - Snell			0.113	
Determination Coefficients of Nagelkerke			0.151	

The results of research second hypothesis summary in table (4) show that determination coefficients of Cox - Snell and Nagelkerke (almost maximum and minimum) are estimated 0.113 and 0.151 percent, respectively. This indicates that approximately 11.3 to 15.1 percent of the changes in the rotation of audit in evaluated corporates are justified by the variables entered into the model. On the other hand, given that the significant level of amount of chi-square

statistic (15.57) is obtained less than 5%, the fitted model is significant. That is to say, tax distortions and control variables can predict the rotation of audit in evaluated corporates very well. Therefore, with the confidence level more than 95% H_0 hypothesis is rejected and H_1 hypothesis is accepted.

The review on the regression coefficients of estimated model variable shows that auditor quality (-1.360) and firm size (-0.669) have a significant negative impact on audit rotation at 5% error level (0.05> sig). These results indicate that the more increase in quality of the auditor and the corporate size, the more decrease will be in rotation of audit in the corporates. Finally, with respect to the obtained coefficients the prediction equation can be formulated as follows:

$$Ln = \left(\frac{Audit\ rotation}{Audit\ non-rotation}\right) = 4.414 + 0.441\ (tax\ distortions) - 1.360\ (Audit\ quality) + 0.229\ (Auditor\ opinion) - 0.669\ (Firm\ size)$$

The Classification Table

The review on the results of the classification table show that for the 130 corporates, there are 12 classification errors for corporates without audit rotation and 33 for corporates with audit rotation. According to the table, the sensitivity of the model to determine the corporates without rotation of audit is 83.3 percent and the corporates with auditor rotation is 41.1 percent. In general, the fitted model has correctly classified 65.4 percent of corporates.

Table 5. The Classification Table of the Dependent Variable of Audit Rotation

Auditor Rotation	Prediction		Correct Prediction Percentage
Auditor Rotation	Lack	Have	
Lack	62	12	87.8%
Have	33	23	41.1%
General Correct Prediction Percentage of the Model			65.4%

The Results of the Third Hypothesis Testing

Table 6. The Results of Third Hypothesis

Variables	Coefficient	Standard Error	Wald Statistics	Significance
Intercept	4.185	1.695	7.835	0.005
Legal Distortions	0.381	0.413	0.85	0.356
Audit Quality	-1.383	0.586	5.568	0.018
Auditor's Opinion	0.309	0.437	0.500	0.480
Firm Size	-0.648	0.242	7.183	0.007
Chi-Square Statistic of Omnibus Test (Significance)			15.33 (0.004)	
Determination Coefficients of Cox - Snell			0.111	
Determination Coefficients of Nagelkerke			0.149	

The results of research third hypothesis summary in table (6) show that determination coefficients of Cox - Snell and Nagelkerke (almost maximum and minimum) are estimated 0.111 and 0.149 percent, respectively. This indicates that approximately 11.1 to 14.9 percent of the changes in the rotation of audit in evaluated corporates are justified by the variables entered into the model. On the other hand, given that the significant level of amount of chi-square statistic (15.33) is obtained less than 5%, the fitted model is significant. That is to say, accounting distortions and control variables can predict the rotation of audit in evaluated corporates very well. Therefore, with the confidence level more than 95% H_0 hypothesis is rejected and H_1 hypothesis is accepted.

The review on the regression coefficients of estimated model variable shows that auditor quality (-1.383) and firm size (-0.648) have a significant negative impact on audit rotation at 5% error level (0.05> sig). These results indicate that the more increase in quality of the auditor and the corporate size, the more decrease will be in rotation of audit in the corporates. Finally, with respect to the obtained coefficients the prediction equation can be formulated as follows:

$$Ln = \left(\frac{Audit\ rotation}{Audit\ non-rotation}\right) = 4.185 + 0.283\ (accounting\ distortions) - 1.383\ (Audit\ quality) + 0.309\ (Auditor\ opinion) - 0.648\ (Firm\ size)$$

The Classification Table

The review on the results of the classification table show that for the 130 corporates, there are 9 classification errors for corporates without audit rotation and 32 for corporates with audit rotation. According to the table, the sensitivity of the model to determine the corporates without rotation of audit is 87.8 percent and the corporates with auditor rotation is 42.9 percent. In general, the fitted model has correctly classified 68.5 percent of corporates.

Table 7. The Classification table of the Dependent Variable of Audit Rotation

Auditor Rotation	Prediction		Correct Prediction Percentage
Auditor Rotation	Lack	Have	
Lack	65	9	87.8%
Have	32	24	42.9%
General Correct Prediction Percentage of the Model			68.5 %

CONCLUSION

In this study, we assessed the relationship between auditor rotation and tax, legal and accounting distortions of corporates listed in Tehran stock exchange. The hypotheses about the significant relationship between auditor rotation and tax, legal and accounting distortions along with the control variables of audit quality, opinion of the auditor and the firm size have been confirmed in multivariate regression model. The research results are important regard to the fact that the more increase in quality of the auditor and the corporate size, the more decrease will be in rotation of audit in the corporates. This means that, based on empirical evidence, in a general conclusion we can say that the presence or absence of auditor rotation has a significant difference with the variety of legal, tax and accounting distortions.

According to the results of previous studies from the viewpoint of accountants and auditors, auditor mandatory rotation will lead to auditors independence increase. In addition, according to the views and studies it can be said that auditor rotation phenomenon is associated with a mix of positive and negative effects. A group of researchers considers this phenomenon positive due to consequences such as increased independence and improved audit quality. Some others mention the reduction of audit quality and audit costs increase as the negative consequences of this phenomenon.

Overall, these findings indicate that the consequences of auditor rotation are certain factors. That is, in this study for the evaluation of research hypotheses, the control variables of audit quality, opinion of the auditor and the firm size have been applied. In order to better study the phenomenon of auditor rotation and its affecting factors in future research, the other factors and variables should be examined. In addition, the users of the financial statements should be aware that auditor rotation can be the outcome of variables other than what is specified in this study.

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