

The relationship between audit tenure and audit quality



This dissertation proposal will investigate the relationship between audit tenure and audit quality in Sierra Leone. 1. 1 Background of the Study The trend of auditing failure cases has attracted wide attention from the public over the years in both developing and developed countries. Several people have started to notice that behind these failures, the auditors of most companies have not changed for a long time.

A long audit tenure is therefore suspected by stakeholders, and so is the audit quality. To improve audit quality, some developed countries introduced a mandatory rotation policy, which was first adopted in the United States in 2002. This policy requires that the audit partner should be rotated at least once every five years. However, such measures have not gone unchallenged as several researchers have been sceptical as to whether it is necessary to rotate auditors. For instance, Gosh and Moon (2003) and Myers et al.

(2003) amongst many other researchers examined the relationship between audit tenure and audit quality before the implementation of rotation policy in previous literature. Their findings suggest that audit quality improves with a long audit partner tenure and, therefore, their evidence does not support the partner rotation policy. In contrast, the opposite conclusion to this idea is proposed by Myers et al. (2005), and Chi and Huang (2005). Meanwhile, some researchers investigate the relationship between audit firm tenure and audit quality rather than partner tenure.

Johnson et al. (2002) suggest a positive association between firm tenure and audit quality while Luo and Huang (2007) found a negative relationship in their studies. The majority of these previous studies investigate the relation

between audit tenure and audit quality using samples before the implementation of the rotation policy. Like in other countries, auditing has also been a usual practice in Sierra Leone for several years. However, little is being known about the relationship between audit tenure and audit quality in the case of Sierra Leone. This study will seek to close the gap by investigating the relationship between audit tenure and audit quality in Sierra Leone.

Different from the previous studies which use either partner tenure or firm tenure to substitute audit tenure, this study will examine the relationships between audit quality and partner tenure, firm tenure separately. 1. 2

Statement of the ProblemThe audit quality issue has been a hot topic for stakeholders for a long time and Sierra Leone is no exception. In Sierra Leone, some auditing firms have been in existence for very long time and they have had a reasonable number of organisations they have rendered auditing service to. On the other hand, most of these organisations have maintained the same auditing firm for several years.

However, little is being known about the relationship between audit tenure and audit quality in the case of Sierra Leone. This study will therefore seek to make a contribution in providing a comprehensive and detail understanding on the relationship between audit tenure and audit quality with special reference to Sierra Leone. It will contribute to the already existing studies on the relationship between audit tenure and audit quality. 1. 3 **The Purpose of the Study**The purpose of this study will be to investigate the relationship between audit tenure and audit quality in Sierra Leone. In this context the study will seek to explore the under mentioned research questions.

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1. 4 Research Questions Many researchers have examined the relationship between audit partner tenure and audit quality before the implementation of a rotation policy in the previous literature. For example, Shokley (1981), Gosh and Moon (2003) and Myers et al. (2003) suggest that audit quality improves with long-audit partner tenure, and, therefore their evidence does not support the partner rotation policy, while Myers et al. (2005) argue that audit tenure has a negative impact on audit quality.

Besides, another group of researchers examines the relationship between audit firm tenure and audit quality. For example, Johnson et al. (2002) suggest a positive association between firm tenure and audit quality, while Luo and Huang (2007) find a negative relation in their studies. As the majority of these prior studies investigate the relationship between audit tenure and audit quality using samples before the implementation of rotation policy, the question here using the case of Sierra Leone are: Does audit tenure affect audit quality in Sierra Leone? Does it necessary to rotate audit firms in Sierra Leone? Motivated by these questions, this study will investigate the relationship between audit tenure and audit quality (using selected companies and firms) in Sierra Leone.

1. 5 Research

Hypothesis Whether and how audit tenure affects audit quality has been discussed over decades.

Some people think that the longer audit tenure help the auditors to be more knowledgeable about their clients and perform better and more effectively than new auditors. The contrary opinion is that the long auditor-client relationship will harm the auditors' independence, as they are very familiar with each other (Chen et al, 2008). Additionally, familiar auditors are more

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likely to compromise in order to retain the client. The mandatory rotation policy's implementation indicates that the regulators regard the longer audit tenure as being harmful to the audit quality.

However, the discussions have not come to an end with the rotation policies. A lot of researchers use the data before the implementation of rotation policy to see whether this policy is worthy; while another group compares the audit quality before and after the year of implementation to check whether audit quality has improved. In this respect, the study will therefore test the following hypotheses: Hypothesis 1: Audit quality does not change with the increasing audit partner tenure Hypothesis 2: Audit quality does not change with the increasing audit firm tenure

1. 6 Significance of the Study

A study of this nature is significant given the importance of audit tenure and audit quality in low income country like ours.

It is therefore necessary to carry out a comprehensive study which will seek to create better understanding of the relationship between audit tenure and audit quality in Sierra Leone. In addition, result and findings generated from this study will provide a framework in formulating policy recommendations geared towards improving how audit tenure affects audit quality in the case of Sierra Leone.

1. 7 Scope of the Study

This study will be limited to Sierra Leone and specifically to firms and companies in the western area that have received some auditing services over the years.

This study will not cover the provinces due to budget and time constraints.

Chapter Two: Review of Related Literature

This chapter reviews the relevant

studies and includes three sections. Section 2. 1 reviews the previous studies on audit quality by using different proxies and determinants while section 2.

2 presents the studies on the relationship between audit tenure and audit quality. Section 2. 3 reviews the prior literature of accruals models. 2. 1 Audit Quality 2. 1.

1 Different proxies of audit quality A number of scholars have started to research audit quality based on different proxies, such as Accruals, Earnings Response Coefficients (ERC) and Audit Reporting Errors. Francis (2004) reviews the last 25 years of research on audit quality and concludes different proxies of audit quality. This section reviews different proxies used in the previous literature as highlighted below. Discretionary accruals Auditors are responsible for inspecting companies' financial statements and report to the public whether they are fair and reliable. Audit quality is perceived to be high if the financial statements are transparent with less probability of manipulation (Chen et al.

, 2008). Therefore, an effective way to detect audit quality is to use discretionary accruals as a proxy. It has been widely used in the previous papers such as Myers et al., 2003; Renolds, 2004; Chi and Huang, 2005 and Choi et al., 2010).

Johnson et al. (2002) take the absolute value of the unexpected accruals as a proxy of earnings quality and find that the quality of financial reports is positively related to audit-firm tenure. Similarly, the absolute value of discretionary accruals is also used to proxy audit quality in Chen et al.

(2008), and Chen et al.

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(2008) to test the association between audit quality and audit tenure and they conclude that the increasing audit tenure does not harm audit quality, while Choi et al. (2010) investigate the relationship between audit quality and abnormal audit fees. Different from the previous three papers, Myers et al. (2003) divide accruals into two categories: discretionary accruals and current accruals, in order to study whether audit firm tenure is associated with accruals. The results suggest that longer audit tenure has positive effects on audit quality. Additionally, Lim and Tan (2010) proxy audit quality by accruals and find that industry specialists provide higher audit quality.

Audit failuresAn audit report plays an important role in communicating between auditors and clients. It conveys professional decisions from auditors to those stakeholders who need this information to invest. The occurrence of audit failure is naturally regarded as a low audit quality. Audit reporting errors are one type of audit failure; therefore they can be used as a proxy of audit quality, such as in Geiger and Rama (2006). In this paper, they classify audit reporting errors into two types. The first is that the companies receiving a qualified auditing opinion do not fail later.

The other is that companies issued with an unqualified opinion go into bankruptcy. Then, Geiger and Rama (2006) investigate whether or not there are more audit reporting errors in non-Big 4 firms, thus better audit quality in Big 4 firms. Another type of audit failure is financial reporting fraud. For example, in Carcello and Nagy (2004), and Geiger and Raghunandan (2002), they examine the association between audit firm tenure and audit quality surrogated by financial reporting fraud. The results suggest that the audit

quality is higher during the short audit tenure by having less possibility of financial manipulation. Cost of debt In Mansi et al.

(2004), they find that both audit tenure and quality have effects on the cost of debt financing and there is a positive relationship between audit tenure and audit quality. Because auditors' opinions have a great influence on the reliability of companies' financial announcements, investors rely on audited financial reports to make an investment decision. Mansi et al. (2004) report that the cost of debt is lower with increasing audit tenure and, therefore, investors do not think longer audit tenure harms the quality of auditing.

Financial report restatement Financial report restatement is the main concern for regulators and stakeholders on the audit quality and financial report quality (Palmrose and Scholz, 2004). Therefore, researchers also take it as a proxy for audit quality, such as in Myers et al.

(2004), to investigate whether the audit firm tenure is correlated with the occurrence of financial report restatements, and Myers et al. (2005) to test the relation between financial report restatements and audit partner tenure. In order to give a more accurate result, their studies chose samples strictly by defining the restatement as 'correlations of financial statements that are non-GAAP reporting' (Myers et al., 2005). Earning Response Coefficients (ERC) Another group of researches use ERC as a proxy to measure audit quality such as Ghosh and Moon (2005), Chi et al. (2005), Skantz (2006) and Ghosh et al.

(2009). In Ghosh and Moon (2005), they use ERC as a proxy for audit quality to examine how investors understand the relationship between audit tenure

and quality. The results suggest a positive association between the two factors, that is, audit quality improves with longer audit tenure. Likewise, with a proxy ERC for audit quality, Chi et al. (2005) conclude that the implementation of a mandatory rotation policy is beneficial to audit quality by analysing Taiwanese companies. Both Higgs and Skantz (2006) and Ghosh et al.

(2009) use ERC as a proxy for audit quality to investigate the relationship between audit fees and audit quality. Higgs and Skantz (2006) report a negative relation between audit fees and audit quality, while there is no evidence found in Ghosh et al. (2009) to support the idea that audit fees are correlated with audit quality. LitigationThe number of litigation activities is used as a proxy of audit quality because it is generally believed that high audit quality auditors have fewer litigation cases. Palmrose(1988) analyzes the relation between audit firm size and audit quality using litigation as the proxy.

Heusesa sample of 472 legal cases involving both large and small auditing firms and suggests that audit quality is better in larger audit firms. 2. 1. 2 Different determinants of audit qualityAccording to prior studies, audit quality is affected by the combination of many factors. For example, audit fees, auditor size, industry expertise and audit tenure. This section reviews the articles about the relationship between different determinants and audit quality respectively.

? Audit fee and audit qualityThere are a lot of articles that discuss the relationship between audit fees and audit quality. For instance, both

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Reynolds et al. (2004) and Frankel et al. (2002) find a positive association between audit fees and audit quality.

But after considering some other factors, such as IPO firms in special areas, Reynolds et al. (2004) suggest no relationship between audit quality and fees. Similarly, Larcker and Richardson (2004) report that audit quality improves as audit fees increase at first, and after using latent class models, a negative relationship presents between audit quality and fees rather than a positive one. A negative relation between audit fee and audit quality is found in Higgs and Skantz (2006) and Hoitash et al. (2007), whereas Ghosh et al. (2009) and DeFond et al. (2002) claim that audit fees do not relate to audit quality. It is worth mentioning that an asymmetric and nonlinear relationship between abnormal audit fees and audit quality is found in Choi et al. (2010). In Choi et al. (2010), they use discretionary accruals as a proxy for audit quality and they consist of 9815 samples in total from 2000 to 2003.

It is the first study to document evidence that the association between the two is asymmetric and suggest that the future research on this topic needs to consider this fee-quality relationship (Choi et al., 2010).? Audit firm size and audit quality In the early studies of audit quality, auditor size is perceived to have no effect on audit quality. However, this view was soon refuted by later papers. DeAngelo (1981) points out that the bigger the audit firms are, the more possible it is auditors perform objectively, i.

e. the higher the audit quality is. Subsequently, more and more research has shown evidence that larger audit firms provide higher audit quality

(Palmrose, 1988; Davidson and Neu, 1993; Lennox, 1999; Geiger and Rama, <https://assignbuster.com/the-relationship-between-audit-tenure-and-audit-quality/>

2006; Francis and Yu, 2009). Palmrose (1988) carried out a study on around 470 litigation cases on both large audit firms and small audit firms (Big 8 and non-Big 8) in the U. S.

and concluded that large firms are less likely to be accused, i. e. there is a better audit quality in large firms. Davidson and Neu (1993) demonstrate the positive relation between audit quality and audit firm size by comparing the forecast errors in large and small audit firms.

Likewise, Geiger and Rama (2006) report that larger audit firms (Big 4) have a better audit quality because they have less auditing errors. Both Lennox (1999) and Francis and Yu (2009) find that the larger audit firms have a greater possibility of issuing precise auditing reports than the smaller ones. Moreover, Sundgren and Svanstrom (2012) conclude that audit quality is better in larger audit offices among the non-top 6 in Sweden, but there is no significant evidence in the Top 6. Industry expertise and audit quality Industry experts are perceived to be more professional and have more experience than non-experts. Therefore, a wave of researches emphasize that the experts in the auditing industry, such as Big 4, have better audit quality than the non-Big 4 audit firms.

Both Balsam et al. (2003) and Krishnan (2003) report that companies audited by industry experts have less discretionary accruals than those audited by non-experts. Likewise, Reichelt and Wang's (2009) research proves that auditors' level of professionalism is crucial to the audit quality. Industry specialists who have a better understanding of this field provide higher quality in auditing. However, Mascarenhas et al.

(2010) fail to prove that accruals are more informative in the companies audited by specialists. 2. 2 Audit tenure and audit quality Audit tenure is also proposed to be another determinant of audit quality by Deis and Giroux, (1992). There are a number of papers that have examined whether and how audit quality is affected by the length of audit tenure.

This section reviews the prior studies on the relation between audit tenure and audit quality. It is divided into two parts as audit tenure includes both audit firm tenure and audit partner tenure, which will be presented in detail when during the course of this study. Chapter Three: Methodology To investigate the relationship between audit tenure and audit quality, descriptive analysis will be completed first in order to introduce the variables. In this analysis, mean, median, standard deviation, max and min will be presented. Secondly, Pearson correlation coefficients will also be reported to test the correlation between variables. Thirdly, multivariate analysis will be used to test the specific relationship between the dependent variable and the independent variables.

In multivariate analysis, I will regress on the absolute value of discretionary accruals on the independent variable and, meanwhile, the value of discretionary accruals, positive discretionary accruals and negative accruals will also be regressed separately on independent variables. Lastly, to check the robustness of the previous results, I will test various model 1 and 2 and on a new sample through adding back some omissions. All the analyses will be performed using in Eviews. The following financial statements will be used in this study: The statements of financial position of each sample The

statements of comprehensive income of each sample The statements of cash
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flows of each sample. The audit reports of each company included in the sample. Conclusion. At the end of the study, the author will come out with specific conclusions, challenges faced and possible recommendations.