

Literature review on audits and auditing



2. 1 Introduction

This chapter reviewed the detail literature on important keys in this research such as the audit, audit firm tenure, audit firm size, fraudulent financial reporting and relevant past research findings on (i) the relationship between audit-firm tenure and fraudulent financial reporting and (ii) the relationship between audit-firm size and fraudulent financial reporting.

2. 2 Audit

Definition of audit is different among many scholars. Audit function is defined by Nagny et al. (2002) to the function that an independent, objective assurance and also consulting activity that designed to add value and improve an organization's operations. In the other study, Kathleen M. Jackson (2010) has further explained that an auditor can perform the two types of audits namely limited-scope or full-scope. It was proven in past studies that some clients opt to choose in receiving a limited scope audit in order to reduce audit costs. In fact, the impact of limited scope exemptions is decreased in audit procedures and as a result it can lead to lower in audit fees. In addition, a long list of audit procedure for investments is needed in the full-scope audit.

2. 2. 1 Quality of Audit firm

The audit services as proposed by Watts (1977) is required as the monitoring methods due to the conflicts that may arise between managers and owners, and also for them who come from different classes of security holders. In addition, in past studies conducted, it was showed that audited statements' provision is the least cost contractual response to intra-owner and owner-manager's conflict of interest, as an example agency costs. The agency costs <https://assignbuster.com/literature-review-on-audits-and-auditing/>

is different from different firms and also for over time to some clients.

Besides, a heterogeneous demand required by clients for the audit services is resulted from different agency cost for some firms such as when the levels of auditing that requested is not as usual. Moreover, Watts (1977) also argued that the audit services' quality is mentioned as the market-assessed joint probability where the auditor is able to find out a breach in the client's accounting system and report the breach. On the other side, the specified audits may enhance the financial information's credibility as the result of the independent verification of management-provided financing reports, thus may minimize the investor's information risk as proposed in the study conducted by Watts and Zimmerman (1986); Mansi et al.(2004), Dye (1993) and Johnson et al. (2002).

On the other side, many past studies has proven that bad financial reporting's quality resulted from short audit-firm tenure as indicated in the study by Johnson et al., (2002); Myers et al., (2003) and Ghosh and Moon, (2005). The above mentioned past studies conducted revealed that low level of knowledge in the early years of an audit and also on the mandatory auditor rotation between audit firms has lead to low quality of earnings owned by a short audit-firm tenure. Based on the result from the past studies, it was known about the mandatory auditors rotations' potential weaknesses of audit firms. But, it also revealed that if the rotation requirement is targeted at auditors within an audit firm, the loss of learning will not happen.

Besides that, based on the past studies conducted by Mautz and Sharaf (1961); Shockley (1981) and Lyer and Rama (2004), there are a lot of

arguments on the issue of client and auditor's relationship's duration might affect the audit quality. One of the studied has proven that audit quality is affected as auditor tenor increases, while on the other study, auditor tenure increase in line with audit quality.

2. 2. 2 Issues in mandatory audit firm

In order to improve the quality in financial reporting, it shown that mandatory audit firm rotation is a solution. Carey (2006) has been argued that in order to improve audit quality, there is a need of policy in the mandatory rotation of audit for particular clients besides able to increase of quality for financial purpose in financial statements. Among countries that practised the policy of mandatory rotation includes: Austria, Australia, Brazil, Greece, India, Italy, Israel, Singapore, South Korea, Taiwan and the USA as mentioned in the past researched conducted by Cameran et al., (2005); Catanach and Walker (1999); Kim et al., (2004); Chi and Huang, (2005); Chi et al., (2005) and Carey and Simnett (2006).

Audit partner rotation such as audit firm rotation can lead to decrease in audit quality as based on the past study, audit partner's knowledge of a client's business increases with his/her tenure on the audit. However, it was revealed that there are a few differences between audit partner and firm rotation which have impact on the tenure on audit quality. Chi et al (2005) has mentioned that audit quality is improved by the audit partner rotation during the first year of the relationship while on the other parts, audit firm rotation lead to decreases audit quality.

Meanwhile, the audit firm rotation is occurs around the world, and even in Malaysia where the issue of audit firms or partners was not specified in detail of Malaysiaan official documents, for example in Companies Act 1965, the Security Commission regulations, approved auditing standards, and so on. It was found that rejection of such rotation idea by the business community is because of lack in official pronouncements on this issue. Even in findings of one study conducted by Jaffar and Alias (2002) showed that only 35 per cent of the audit firms' partners and only 32. 4 per cent of the chief finance officers surveyed favored audit firm rotation every three years of engagement. Meanwhile, the Edge (2002) has revealed that in light of the Enron case, the Chairman of the Malaysian Accounting Standard Board announced the intention of the board to make it mandatory to rotate the audit firm once every five years.

2. 3 Audit firm tenure

In the definition of audit firm tenure, Johnson et al. (2002) has clarified that the audit firm tenure is the number of consecutive years that the audit firm has audited the client (computed by counting backward from the year the fraud began). The definition of short auditor tenure is explained by Carcello et al. (2004) by the meaning of three years or less and long auditor tenure as nine years or more. Based on the previous studies conducted by other academicians, the other researches on this term revealed that imposing mandatory limits on auditor tenure is expected to improve audit quality by reducing client firms' influence over auditors as proposed by Turner (2002); Brody and Moscovice (1998); SEC 1994; AICPA 1978; U. S. Senate (1977) and Mautz and Sharaf (1961).

2. 3. 1 Short audit- firm tenure

From the previous study conducted by Aminada and Paz-Ares (1997), the scholars has suggested that in order to replace client-specific assets, it will involves a technological limit, if not most, of them cannot be replaced immediately. Due to this, the financial-reporting quality is projected to increase as client-specific knowledge also increases in the early years of an audit engagement. Meanwhile, a client-specific asset (such as knowledge) that in line with transactions costs may allow the incumbent auditor to earn quasi rents from maintaining existing client relationships as specified by DeAngelo (1981). It was further suggested that if the existence of quasi rents skews the auditor's incentives toward maintaining the client relationship, financial-reporting quality could be reduced in early engagement years.

2. 3. 2 Long audit- firm tenure

As proposed by Shockley (1981), it was mentioned that the impact of the long relationship audit firm is by having a “ learned confidence” in the client besides the scholars also suggests that the above mentioned learned confidence may result in the audit firm using less strenuous and less innovative audit procedures. Another author, Knapp (1991) in his past study on audit firm tenure has further defined that different audit tenure in an experimental setting besides able to gather that experienced audit committee members perceived that auditors with 5-year tenure were more likely to detect errors than auditors in the first year of an engagement or auditors with audit tenure of 20 years. On a part of it, Geiger and Raghunandan (2002) found that short-tenure auditors to issue going-concern opinions for clients that subsequently declared bankruptcy as compared with long-tenure auditors that is still on the preference in this study.

2. 4 Audit firm size

In term of the audit firm size, it was revealed that smaller audit firms have justified proposed wealth transfers from clients and from larger audit firms, where in general the audit quality is independent of auditor size as supported by Deangelo (1981) in his study. Moreover, in some of the audit quality term, where it was found in the study done by previous researchers, the term of quasi-rents, it might serve as collateral against such opportunistic behavior in the subject to loss from discovery of a lower-than promised audit quality. This finding can be proven on the theory of ceteris paribus, where the less incentive the auditor has to behave opportunistically and the higher the perceived quality of the audit when the larger the auditor as measured by the number of current clients and the smaller the client as a fraction of the auditor's total quasi-rents is exist.

The famous author on the theory and study done, namely DeAngelo (1981) also argues no single client is important to larger accounting firms as accounting firm size is a proxy for auditor quality, and beside, larger accounting firms are less likely than smaller accounting firms to compromise their independence. In fact, theory supported by the research taken by Dopuch and Simunic (1980) who further proposed that larger accounting firms provide higher quality services because they have greater reputations to protect. It finally defined that quality is not independent of auditor firm size when incumbent auditors earn client specific quasi-rents. Moreover, audit fees do not meant to be adjusted in full term to the incumbent auditors, with the view to the extent that the bilateral monopoly between client and incumbent auditor implies a sharing of these costs mentioned,

whereby in the above mentioned case, a successful prevention of discrimination which refer to the competition from large audit firms that definitely represents a windfall gain to smaller auditors at client expense. Therefore, it can serves as an excuse to justification of the wealth transfer results from a wealth transfer from clients to smaller audit firms which under this scenario of voluntary contracts might become unfair and discriminate smaller firms.

2. 4. 1 Big-Four & Non Big-four

There are many previous studies that caught on the interest of the Big-Four and Non Big Four issues, where to further understanding of the larger audit firms (Big 4) which perceived as more capable of maintaining an adequate degree of independence than their smaller counterparts because they usually provide a range of services to a large number of clients, hence reducing their dependence on certain clients as mentioned by Dopuch (1984) and Wilson and supported also by study conducted by Grimlund (1990). The past literature that has review by Lawrence et al (2011) suggested that Big 4 firms can provide a superior audit quality as their sheer size would definitely able to support more complete training programs, standardized audit methodologies, and more options for appropriate second partner reviews. In addition, Deangelo (1981) has explained that it can't be deny that larger audit firms are generally perceived as the provider of high audit quality and might enjoy a high reputation in the business environment and as such, would strive to maintain their independence to keep up their image where it also supported by Dopuch (1984) and Wilson and Grimlund (1990). To enhance further the theory (Chow and Rice, 1982) has proven

that larger audit firms are also perceived to be more independent than their smaller counterparts in managing management's pressure where in the event of disputes as they normally have more clients and can afford to give up some of their more difficult clients. In the different environment as in Malaysia, Teoh and Lim (1996) has found out that the high dependence on a few clients has been found to affect perception of independence. However, to come to the true situation, this is not consider as something new as the market for audit services for public companies in Malaysia is dominated by the international Big 4 which is previously known as the Big 6 audit firms. In fact, Che-Ahmad and Derashid (1996) reported findings from their study that the Big 6 (and their affiliates) audited 75.9 per cent of the Bursa Malaysia which is the Main Board as listed companies in 1991.

The past literature conducted by scholars based on their past researches, the length of tenure by Big 4 audit firms is longer as their clients would be less likely to switch them compared to their smaller firms who compete in the same industry. Moreover, it was also found that the choice of audit firm can be related to the size of the auditee and the type of services needed besides the possible effect of the type of audit firms on the length of tenure. In fact, it has been also argued by Watts and Zimmerman (1986) that larger auditees are demanding highly independent audit firm to reduce agency costs due to the complexity of their operations and the increase in the separation between management and ownership and also auditors' self-interest threat as found from the study by Hudaib and Cooke (2005). In the different area of past research, Palmrose (1984) has further supported that the number of agency conflicts also increases and this might increase the

demand for quality-differentiated auditors such as the Big 4 audit firms as the size of the companies' increases.

In fact, based on the previous findings, Becker et al. (1998) further supported on the Big 4 issues whereby on the situation of 4 clients report lower absolute discretionary accruals than non-Big 4 clients. Another similar issue as revealed based on the past findings conducted by Francis et al. (1999) who has suggested that Big 4 auditors constrain opportunistic and aggressive reporting because their clients have higher total accruals but lower discretionary accruals while on the other hand, Krishnan (2003) found that there is a greater association between future earnings and discretionary accruals for Big 4 than for non-Big 4 clients. Due to the following literature, the previous researches conducted have been done by using discretionary accruals as the mentioned scholar's first measure of audit quality. The reason of applying the measure is known as it reflects the auditor's enforcement of accounting standards. Another consent that revealed in the past finding of research based on the study by Guay et al. (1996) is on the limitations on the effectiveness of an audit in constraining earnings management as it only partially effective, as discretionary accruals not only reflect management's opportunism, but also management's signalling attempts and random noise. Moreover, it was seen from some of the previous study proposed by academicians that the Big 4 auditors provide more assurance to the market than non-Big 4 auditors by the fact found that Big 4 clients have more credible earnings than those of the non-Big 4 clients then, *ceteris paribus*, the Big 4 clients should receive a break in their cost-of-equity capital. Khurana and Raman (2004) has revealed in their studies that

in the U. S , there is a lower ex ante cost of capital of Big 4 clients as compared with non-Big 4 client, but unable to find such a difference in Australia, Canada, or Great Britain. Another scholar, Behn et al. (2008) has included analyst forecast accuracy in his study as an audit-quality proxy, where they argue that if one type of auditor increases the reporting reliability of earnings in comparison to the other type, then, ceteris paribus, analysts of the superior type's clients should be able to make more accurate forecasts of future earnings than those analysts of the non-superior type's clients. On view of that, Behn et al. (2008) has concluded that it is definitely the analysts of Big 4 clients have higher forecast accuracy than analysts of non-Big 4 clients. In the study, the analyst forecast accuracy is used by Chi et al. (2005) as their third audit-quality measure to proxy for an enhanced level of decision making by sophisticated financial statement users where it was revealed that differences in quality between Big 4 and non-Big 4 audit firms could be a reflection of client characteristics. In fact, from the result showed based on the findings of each study that used the matching models or controlling for an extensive list of client and auditor variables, can be found that the treatment effects of Big 4 auditors are insignificantly different from those of non-Big 4 auditors with respect to discretionary accruals, the ex ante cost-of-equity capital, and analyst forecast accuracy.

2. 5 Fraudulent Financial Reporting

There were many standards of audits in the world, as in the specific area, namely Malaysia has stated that the Malaysian Approved Standards on Auditing, AI 240 on “ Fraud and Error” (MIA, 1997) is requires the auditor to assess the risk of fraud and error during the audit of financial statements.

Under the standard also, the auditor should design audit procedures to obtain reasonable assurance that misstatements arising from fraud and error that are material to the financial statements taken as a whole are detected that based on the risk assessment. It means that the responsibility has to be put on the external auditor shoulder whereby if he/she is unable to detect material misstatements, particularly intentional misstatements, they may be exposed to litigation. Due to the matter, Kaminski (2002) has summarized on the fraudulent financial reporting as a critical problem for external auditors because of the damage to professional reputation that results from public, especially on client's side's dissatisfaction about undetected fraud.

A few literatures and findings conducted by many scholar such as the studies by Mitchell, (1997); Grant, (1999) and Spathis, (2002) on the Fraudulent financial reporting proven the fact that the scenario has occurred in many countries as in the United Kingdom (UK) and United States (US) which have reported the seriousness of fraud activities as further supported by other scholar, Tyler, (1997); Wells, (1997); Mitchell, (1997); Vanasco, (1998); and Grant, (1999). In view to this, Johnson et al (2002) has revealed in his study that a lot of response to one or more audit failures in line with critical of the public accounting profession has determined to be in long relationships between auditors and client management result in a decline in audit quality and are not in the public's interest. To overcome the situation, a possible solution that proposed is the mandatory auditor rotation whereby the findings will be on the profession which will increase audit costs and will not improve audit quality (and in fact may reduce audit quality). On the other side, in some country where the audit-firm rotation is not mandatory, usually

in the current regulatory regime, long audit-firm tenures are associated not with a decline in financial reporting quality. By referring to previous researches, it can be concluded that the quality of audit services is means to be the market-assessed joint probability which a given auditor will eventually discover a breach in the client's accounting system, and may report the breach which given that probability that a given auditor will discover a breach is depends on the audit procedures, auditor's technological capabilities, the extent of sampling and so on. In fact, the same literature based on the past study has determined that the conditional probability of reporting a discovered breach is a measure of an auditor's independence from a given client. To enhance the understanding of this, the definition of auditor independence is used in DeAngelo (1981) and Watts and Zimmerman (1981), who has been argue on the ex ante value of an audit depends on the auditor's incentives to disclose selectively ex post. To add some more, a statement proposed by Watkins et al. (2004) in his study has explained that auditor independence and competence are critical elements affecting the credibility and reliability of an auditor's report and, therefore, financial reporting credibility.

2. 6 Past researches

2. 6. 1 Audit firm tenure and fraudulent financial reporting

There are a lot of findings and conclusion reviewed by previous scholars from different view, whereby according to study conducted by Carcello et al. (2004), who has stated that there was only limited research on the relation between audit firm tenure and audit quality. On the other study conducted by casterella et al. (2005), conclusion was made that audit quality is lower

given longer auditor tenure besides also suggested that audit failures are less (more) likely when auditor tenure is short or (long). Meanwhile, the finding has been denied by Chi and Huang (2005) who declared that long audit partner tenure is associated with reduced earnings quality. It is further mentioned that the two aspects of auditor tenure namely the tenure of the audit firm and the tenure of individuals engaged in the audit, particularly the engagement partner which imply that even though both aspects have been tested in the literature, the emphasis has been on audit firm tenure due to difficulties in identifying the engagement partner in most countries. It finally has come to complicated conclusion which shown that the empirical evidence of the effects of audit firm tenure on audit quality is combined and mixed.

Apart of it, Casterella et al. (2002) and Choi and Doogar (2005) mentioned that Studies report which audit quality decreases with audit firm tenure, which may includes the auditor's failure to detect fraudulent financial reporting or argument by Davis et al.(2002) is on the issuing of going concern opinions before bankruptcy and a positive relation between audit firm tenure and discretionary accruals. Different point of view and proofs from different studies, revealed that audit quality increases with audit firm tenure while another famous scholar in this study, Johnson et al. (2002) proven that the absolute value of unexpected accruals is higher in the early years of audit firm tenure in his study conducted.

Recent finding on the past researches conducted and published in US as the effect of audit firm tenure (AUDTEN) on audit quality study conducted by many scholars namely Ghosh and Moon (2005); Carcello and Nagy, (2004);

Myers et al., (2003); Johnson et al.,(2002); Geiger and Raghunandan, (2002) where the results proven that in the situation of audit tenure increases, audit quality also increases. Fargher et al, (2008) has shown result in his study that audit failures are most likely to occur in the first few years of tenure of an audit firm while several prior US studies have attempted to debate on the auditor tenure. In some other findings gathered include in the study conducted by Deis and Giroux (1992) who supported that audit quality decreases as auditor tenure increases, whereby in contrast, St Pierre and Andersen (1984) found firms that detected errors and experience higher legal risk than auditors with a tenure greater than three years is based on the auditors of new clients (three years or less on the engagement) commit. The former statement has further supported by Knapp (1991) which based on audit committee members' responses to the survey, able to concludes that as auditors gain more experience with individual clients, the likelihood of discovering material errors increases while Geiger and Raghunandan (2002) has come to conclusion that short-tenured auditors is not efficient in the collection and evaluation of evidence as compared to long-tenured auditors. Obviously, based on finding gathered from different type of studies conducted, it can be concluded that their results are consistent with long-tenured auditors having a more in-depth knowledge of their clients' financial status and operating systems than short-tenured auditors. However, Carcello and Nagy (2004) have concluded from their study that fraudulent financial reporting is more likely to occur in the first three years of an audit as they have not provide proofs and evidence of greater fraudulent financial reporting by clients of long-tenured auditors. On the other study conducted by Myers et al. (2003), it was revealed that tenure and earnings can be

considered as quality where the auditor-client relationship lasted for at least five years whereby they find that the magnitude of both discretionary and current ACC declines with longer auditor tenure. To further support it, Myers et al. (2003) concluded that high audit quality is determined based on the longer auditor tenure constrains managerial discretion with accounting accruals while on the other study conducted, Johnson et al. (2002) has revealed that accruals are more bigger and less persistent for firms with short auditor tenure relative to those with medium or long tenure. Finally in contrast, Davis et al. (2002) has concluded that audit quality might declines with extended tenure as the reason on tenure increases, client firms may have greater earnings forecast errors decline and also reporting flexibility.

Another findings from studies conducted by Beck, Frecka and Soloman, (1988); Carcello and Nagy, (2004); Johnson, Khurana and Reynolds, (2002); Meyers, Meyers and Omer, (2003); Ghosh and Moon, (2005) has definitely supported the facts of auditors with long tenure have comparative advantage in this respect as they develop client-specific knowledge and deeper understanding of clients' business process and risk whereby with the proofs as that fraudulent financial reporting is most likely to occur in the first three years (termed as " short" tenure) of auditor-client relationship.

However, these studies conducted by the above mentioned scholars has failed to state any evidence that longer audit firm tenure (i. e., nine years or more) is associated with reduced financial reporting quality. Apart from that, another authors, Meyers and Omer (2003) in the study has examined on the association between audit firm tenure and earnings quality where auditor-client relationship lasted for at least five years, which lead them to come up

with conclusion that longer auditor tenure constrains managerial discretions with accounting accruals, which suggests high audit quality (i. e. audit firm tenure is negatively related to both the absolute discretionary and current accruals and signed positive discretionary and current accruals, and positively related to both the signed negative discretionary and current accruals). Long-tenured auditors are more efficient as it based on the opinion view of Geiger and Raghunandan (2002) from the study conducted which based in the collecting and evaluating evidence than short-tenured auditors because long-tenured auditors have more in-depth knowledge about their clients' financial status and operating systems than short-tenured auditors.

The other study conducted by Nashwa George (2009) on The Relationship Between Audit Firm Tenure And Probability Of Financial Statement Fraud which has proven the long auditor tenure for a particular client which close auditor-client relationship has the potential to impair auditor objectivity in assurance functions leading to reduced financial reporting quality with the study's objective of finding out whether audit firm and client relationship is in any way related to a potential fraud risk situation in financial reporting is also determined. Another scholar, Beneish (1999) and Lundelius (2003) also has proposed on the using of five fraud indicators as the direct measure of the probability of financial statement fraud and examine whether these fraud indicators are related to audit firm tenure as used by George (2009) in this study. It shown that by using the cross-sectional multivariate regression analysis, the results in the analysis show that most fraud indicators are significantly negatively associated with audit firm tenure (expressed in terms of number of years of audit firm and client relationship). The results also

supported by some previous researches which conducted by Carcello and Nagy (2004), Myers, Myers and Omer (2003) and also Johnson, Khurana and Reynolds (2002) that proven a long audit firm tenure is not related with reduced financial reporting quality, however mentioned that financial reporting problems are found to be mostly confined to the initial years of auditor engagement. Based on the review, these previous studies is very important and contribute to the audit literature by employing a direct measure of financial statement fraud and demonstrating a systematic negative association between audit firm tenure and probability of financial statement fraud.

According to Casterella et al. (2002), there are two aspects of auditor tenure identified namely tenure of the audit firm and the other one is tenure of individuals engaged in the audit, which is particularly the engagement partner. The scholar has argued that even though the two mentioned aspects of tenure had been studied in past research, the audit firm tenure still need to be analyze further due to difficulties in identifying the engagement partner in most countries, since different countries are facing different rules and requirements. Besides, impacts on audit quality by the audit firm tenure are proven at the same time. Based on the past studies conducted by a few scholars namely Casterella et al. (2002) and Choi and Doogar (2005) has proven that audit quality decreases with audit firm tenure, that might includes inability of the auditor to detect fraudulent financial reporting or issuing going concern opinions before bankruptcy and a positive relation between audit firm tenure and discretionary accruals as further supported by Davis et al. (2002). In fact, the other study developed

by Johnson et al. (2002) has also proved that audit quality increases with audit firm tenure. It was supported from the findings of the study which stated that the absolute value of unexpected accruals is higher in the early years of audit firm tenure. On the other side, Myers et al. (2003) has reported a negative relation between audit firms in his past research conducted.

2. 6. 2 Audit firm size and fraudulent financial reporting

Research conducted by Sinason et al. (2001) on the length of audit tenure has come up to conclusion to be positively affected by the type of audit firm whereby it means that smaller audit firms experience shorter tenure compared to their larger counterparts who often enjoy lengthy tenure. Another finding based on the previous studies is difficulties faced by small firm in the long run in order to keep their existing clients and at the same time maintain a high degree of independence and objectivity due to increased competition and size mismatch as differences in the length of tenure between the two types of audit firms which could impair independence. It was proposed and learned from previous cases that the size of audit firm should match the size of auditee whereby when a size mismatch happened between large auditees audited by small audit firms could cause termination of the audit engagement as proven by Hudaib and Cooke (2005).

From the previous literature and analysis based on previous researchers, Win the situation where client-specific quasi-rents vary across clients, auditor size is continues to serve as for the audit quality because larger auditors possess greater total collateral, but a full focus on size alone is not effective

as it does not inform consumers about the relationship between the quasi-rents specific to one (potentially large) client and the auditor's total quasi-rent stream. Due to this matter, it was