The Role of Auditor's Cooperation Duration with Client Organizations and its Impact on Auditor Independence by evaluating the Quality of Financial Statements

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Abstract: Quality of the financial statements provided by the companies has a special important. Users of financial statements should rely on correct and real financial reports. Therefore, audit of financial statements is of special importance. In this study, the role of the auditor's work with client organizations and its impact on auditor independence through evaluating quality of financial statements for the period of 1999 to 2008 will be investigated. The results of testing variables showed that, there is not a significant relationship between auditor's work duration with customer and the quality of financial statements that measured by abnormal accruals. In addition, the impact of other variables influencing the level of abnormal accruals including firm size, profit or loss, financial leverage, debt, operating cash flow, and type of audit suggest that, variables of financial leverage, operating cash flow, audit type, and firm size have no significant relationship with of abnormal profit accruals. In addition, there was no significant relationship between the duration of audit work and accruals.

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1. Introduction

The basis of the policy of periodically changing audit is observing the quality of auditing reports from long-term cooperation with client companies. After a long time of the audit work, it can be seen that, the continuity of communications between the auditor and auditee institutions may affect the auditor's independence as well as his/her statements. This leads to undermine their independence and professional competence and from the other hand, impose social costs to the client company. The concept of the independence is one the important features of the auditing profession and investigating the factors influencing it is essential. Therefore, familiarity with the concept of independence, influencing factors, and removal of reducing agents are necessary. Regulations of the professional behaviors were developed in different countries in relation with auditing profession and each try to define practical examples in the context of transactions, financial interests, and commercial and non-commercial relationships. Moreover, in most countries, in relation with providing professional services to companies listed on the Stock Exchange, rules and regulations of Securities and Exchange Commission considered stringent requirements because of the sensitivity of the issue. Quality of financial statements provided by the companies is important. Users of financial statements should rely on correct and real financial reports. Therefore, auditing financial statements is of special importance. Changing auditing agencies, is one of the policies around the world with the goal of improving the audit of financial statements. It is important to note that, it is claimed that, working with an audit agency for a long time, reduces the quality of audit reports and the financial statements. Policies of limiting cooperation duration with audit institutions have become important tools to improve the quality of audit reports and the financial statements.

It is said that, the advantages of changing auditing agencies are maintaining auditor's independence and reducing the cases that became unimportant through long-term collaboration. In this study, we will examine the impact of working duration on the quality of financial statements by reviewing abnormal accruals. In this study, we will examine the effect of this duration on increasing or decreasing the quality of financial statements through continuously publication of abnormal accruals. Sometimes, corporate's executives use accounts as a tool to indicate achieving unrealistic long-term goals or artificially reducing perceived risk. Accrual accounting grants considerable choices to managers in determining profit at different periods of time. In fact, under this type of accounting system, managers have a considerable control on the detecting some of the cost items, including the cost of advertising and R&D, thus changing auditors periodically and its relation with quality of financial statements will be investigated in this research.

Works of Carpenter and Strawser (1971) showed that, changes in the companies' management are one of the factors influencing auditor changes. Furthermore, the high number of shareholders has an impact on the conflict of interests between management and ownership. However, in the research of Schwartz and Menan (1985), no significant relationship was observed between changing management and changing auditors. In addition, Defond (1992) concluded that, the changes in managers who are shareholders in the company have led the companies to invite accredited institutions (eight large institutions) to audit firms. Palmrose (1984), and Francis and Wilson (1988) also showed that, scattering of ownership has a significant effect on changing auditor and the existence of major shareholders decreases the auditor changing.

Muatz & Sheref (2003) in their paper, although did not recommend the periodic change of auditors, but stated that, the long-term relationship will cause doubts about the independence of the auditors. Works of Di Angelo (1998) indicate that, auditors have a kind of advantages by maintaining their client due to the initial costs of presence of new auditor and clients undergo extra costs when changing auditors. Palmrose (1989) showed that, when the relationship between the auditor and the client becomes longer, the working hours of auditors will be reported less than actual. This expected advantage-like benefit for the auditee and the auditor, may lead to competitive actions from auditors such as lower pricing of audit services from avoidable costs in order to maintain their clients. Furthermore, from the economic point of view, this phenomenon is a normal competitive response of auditors to attract new employers to take the advantage of future aforementioned benefit, thus their incentives to maintain their clients in the years after, will be questioned the independence of the auditors.

Studies by Geiger and Raghunandan (2010) on companies that have declared bankruptcy in the years between 2012 to 1998 showed that, there is a positive relationship between duration of auditors working and the client and the likelihood of that, bankrupted company had received a conditional report in terms of continuing activities at the year before bankruptcy. Therefore, based on their results, it is not recommended to change auditors periodically. In other words, it can be concluded that, there is a learning curve or better understanding over the time in relation with auditee's status for the auditor. Therefore, periodic and change of auditor reduces auditing quality.

Andreev Jackson (2007), in a study on the change of auditing agencies and the auditing quality, investigated the relationship between duration of working with auditing agencies and the quality of audit in Australia. He used two criteria to measure audit quality: the amount of publishing continuous reports and the amount of abnormal accruals. He used a common pattern to examine current changes in the capacity and quality level of auditing. The conclusion was that, audit quality increases with increasing the rate of periodic changes of auditors when they use the index of continuous and uniform audit reports release and is not affected when they use abnormal accruals. The existing literature supports this hypothesis that, in optional changing of auditors, the audit quality in the early years of the audit work is lower, while experimental evidences on the effects of maintaining an auditor for long-term period has ambiguous results. In this study, we investigated the effects of short-term, intermediate, and long-term periods of maintaining audit institutions to improve the quality of financial reports. Therefore, in this regard, one of the major policies on reforming the relationship between the audit firms and the clients as well as the relationship between periodic changes of audit firms and the audit quality have been investigated. In this work, we determined the information that is the basis of auditor's changing policy. The findings of above studies suggest that, there is a continuous reduction in audit quality in association with long-term audit tenure. In Jackson's study, the data for the years before 1995 of Australian companies were selected because before that year, there were no time requirements for an audit firm. The results showed that, there is a positive and significant relationship between audit firm tenure and increased reliance on audit reports that reported company's status as desirable. About the second factor of measuring the quality of financial statements, there was no result on capital adequacy of the company and the long-term tenure of auditing firms. About the third factor of measuring the quality of financial statements that examines the quality of earnings, a negative relationship between quality of reported earnings and increased cooperation with audit firm was accepted. In his study, the closer we get to the final years of the audit report, the lower is the reported quality of earnings.

Larry and Monroe (2003), in a study using data obtained from actual audits performed by three large auditing firms in the USA have examined whether there is a relationship between reducing the quality of audit services measured by abnormal accruals and periodic changes of auditors. The study concluded that, abnormal accruals are negatively and significantly associated with periodic changes of auditors. It seems that, with the increase of the rate of periodic changes of auditors, audit quality will be increases. After controlling firm size and evaluating the risk of the client companies as control variables, they have found a negative and significant relationship between abnormal accruals in small-scale customers and periodic changes of auditors for more than 7 years in companies that have been equalized based on risk levels. They also found that, periodic changes of auditors in large companies are not significantly related to abnormal accruals. This result confirms that, the larger cooperation time of an auditor and a small client increases the likelihood of errors in customer's financial statements, while for large companies auditors changes has no impact on the quality of audit.

2. Material and Methods

Scope of this research is all companies listed on Tehran Stock Exchange that meet following conditions:

1. Have entered stock exchange before 1999
2. During the period of 1999 to 2008 the information about financial statements, annex notes, and the names of auditing agencies will be available

In the present work, we used modified Jones model to determine abnormal accruals. Jones identified difference between profit and cash flows from operations as accruals. In this approach, the prevailing opinion is that, the information in the cash flows from operations is a more objective measure for evaluating the real economic performance of a firm and hence management manipulation could be lower. Jones (1991) suggested a model to investigate earnings' management assuming that, non-discretionary abnormally accruals are constant over the time. In this model which tries to separate discretionary and non-discretionary accruals there is an attempt to control the economic conditions of a firm affecting non-discretionary accruals. In the first step of the described model, the relationship between total accruals for a specified time period, so-called event period, and the variables of sales, properties, machinery, and equipment is estimated as follows:

$$\frac{TA_{it}}{A_{it-1}} = \alpha_1\left(\frac{1}{A_{it-1}}\right) + \alpha_2\left(\frac{\Delta REV}{A_{it-1}}\right) + \alpha_3\left(\frac{PPE_{it}}{A_{it-1}}\right)$$

Where, TA represents total accruals, A is total assets, REV is total revenue (sales) and PPE is properties, machinery and gross equipment. After estimating the model parameters, the model, through time series or cross-sectional models, calculates non-discretionary abnormal accruals for "estimation period" as follows:

$$NDA_{it} = \alpha_1\left(\frac{1}{A_{it-1}}\right) + \alpha_2\left(\frac{\Delta REV}{A_{it-1}}\right) + \alpha_3\left(\frac{PPE_{it}}{A_{it-1}}\right)$$

Dechow et al. have developed a modified form of the Jones model. According to them, Jones model, implicitly assumes that, the items of income will not be manipulated by management neither during estimating the model parameters (event period) nor during the estimation of earnings' management (estimation period). Violating this assumption, they consider changes in sales (revenue) in the estimation period as a result of earnings' management. Therefore, including the changes in accounts receivable in the Jones primary model, modified Jones model as follows:

$$NDA_{it} = \alpha_1\left(\frac{1}{A_{it-1}}\right) + \alpha_2\left(\frac{\Delta REV - \Delta REC}{A_{it-1}}\right) + \alpha_3\left(\frac{PPE_{it}}{A_{it-1}}\right)$$

In the above equation REC is equal to accounts receivable.

After estimating abnormal accruals in the studied period using linear regression analysis between abnormal accruals (dependent variable) as an indicator for the quality of earnings, and consequently financial statements and the length of cooperation with auditing agencies (independent variables) the above relation will be investigated. To determine and neutralize the effect of other variables influencing the results, such as firm size, sales growth rate, debt volume, and the rate of return on assets they will be entered into the model as control variables. Control variables will be calculates as follows:

1. Firm size is the book value of assets per year
2. Sales growth is the rate of sales changes of each year per previous year
3. Debts volume is the ratio of total debts to total assets
4. Rate of return on assets (ROA) is the ratio of net income to total assets

The linear regression model is as follows:
DA=f(AT,(size,cfo,lev,ROA))
Where,
DA is abnormal accruals
AT is cooperation time with auditing institutions
(Size, cfo, lev, ROA) are control variables

The statistical population of the survey is all firms listed in Tehran stock exchange that their financial data and information is available during the studied period of all financial data and their reports. Systematic simple random sampling was used to select samples.

3. Results

Table 1 shows the descriptive statistics of variables used in this study. Statistics of each variable of mean, median, standard deviation along with minimum and maximum values are given.

Table 1: Summary of descriptive statistics for the sample firms (n=2352)

Variable	Mean	Median	SD
DAC	0	0	0.11,215,190
CFO	156,480.72	69,922.9	262,563.56
Lev	0.7,648	0.82	0.18580
Size	492314	320,535	91,230
Loss	0.1,518	0	0.35,889
At	4.7921	4	3.05,579
Auditor	0.39	0	0.489
Variable	Minimum	Maximum	
DAC	-0.929	0.0,943.	
CFO	-929,379	3,850,747	
Lev	0.0,806	0.99	
Size	5,755	11,916,741	
Loss	0	1	
At	1	13	
Auditor	0	1	

Correlation matrix of variables used in this study is presented below.
The objectives of correlation matrix in this study are as follows:

1. To provide an initial picture of the relationship between the variables in this study and;
2. To provide preliminary evidences on the auto-correlation between independent variables.

Table 2: Poisson correlation coefficient between the variables (n=2352)

	DAC	Cfo	Lev	Lnsize	Lloss	At	auditor
DAC	1						
Cfo	-0.135 **	1					
Lev	-0.114 **	0.296 **	1				
Ln size	0.084 **	0.514 **	0.114 **	1			
Loss	0.061 **	-0.093	-0.132 **	-0.148 **	1		
At	0.053 **	0.037	-0.057 *	0.169 **	-0.128 **	1	
Auditor	0.030	0.129 **	0.108 **	-0.011	0.090 **	0.253 **	1

** Correlation is significant at the 1% level.
* Correlation is significant at the 5% level.

To determine whether the mean of abnormal accruals (DAC) as well as other independent variables among these three groups of At have significant difference, we have used the mean difference test. The results of this comparison are presented in Table (3).

Table (3): Comparison of mean of variables at different levels of the independent variable during the audit time (At)

	Mean		
Variables	Short	Median	Long
DAC	-0.00601167	-4.28666E-1	0.011755653
CFO	150610.6795	155912.6074	172829.4002
LOSS	0.197029703	0.168894289	0.090497738
Lev	0.776850345	0.766063016	0.744481947
LnSize	422652.8069	492314.3436	770328.0795
	(T-test Differences)		
	Short-Median	Long-(Short)	Long-Median
DAC	0.0,068	0.0,177 **	0.0,109
CFO	3,215	22,219	19,004
LOSS	0.522	0.107 *	0.0,845 *
Lev	0.0,121	0.0,202 **	0.0,323
LnSize	0.001	0.403 *	0.402 *

The results show that, the difference between the means of abnormal profit accruals at level 1 (short - median) and Level 3 (median - long) is not significant but it is significant at level 2 (short - long) at 10%, so we can conclude that, with the increase of audit time to more than 7 years, the amount of abnormal profit accruals, compared to less than 3 years period, will be increased and the duration of audit time have influence on the amount of abnormal profit accruals. Comparing operating cash flow in three levels of 1, 2 and 3, it can be seen that, the difference between the three groups is not statistically significant at error level of error of α=5%. In addition, the number of losser firms in different groups of At are significantly different and the mean of financial leverage has no significant difference between these three groups. The mean of logarithm of the firm size in the groups classified according to the audit periods of short-term and long-term have about 40% difference and I companies in which have higher audit time (At) the auditing by the agencies is higher too.

5. Conclusion

The results of testing variables indicated no significant relationship between the audit time and the quality of financial statements that measured by abnormal accruals. In addition, other variables influencing the level of abnormal accruals including firm size, profit or loss, financial leverage, debt, operating cash flow, and type of audit suggests that the variables of operating cash flow (CFO), Financial leverage (LEV), firm size (LN SIZE) and auditing type (auditor) have no significant relationship with abnormal profit accruals, in addition, auditing duration lacks significant relationship with accruals. Moreover, the separation of accruals into two positive and negative groups, considering the absolute value of abnormal accruals, and investigating its relationship with the auditor and the client cooperation duration (At), does not significantly change the results. In other words, it can be said that, in listed companies in Tehran Stock Exchange, there is no significant relationship between abnormal accruals of earnings as an indicator of quality of financial statements and the cooperation period. The results of the study are in agreement with the results of Johnson (2010), Muatz & Sheref (2003), and Jackson (2007). In other words, there is no significant relationship between audit time and reported quality of earnings and hence the quality of financial reports and audit reports.

Applied research proposals

According to the results, it was found that, in the firms listed in Tehran Stock Exchange, the period of continued cooperation with the audit is not effective on financial statements, so it is recommended that:

- Legislators and authorities revise the developed requirements about changing auditor after 5 years of continuous auditing.
- Investors and creditors assess the quality of audit reports and financial statements of companies irrespective of the audit duration and consider the role of other factors on auditor's with greater accuracy.
- Scholars and researchers, using different parameters including the cost of capital or predicted EPS, investigate the effect of audit time on the quality of the financial statements to provide additional evidences in this field.

Limitations of this research:

- Lack of access to necessary data in order to estimate abnormal accruals using other methods.
- Lack of access to financial data of the companies for the years before 2012, so that determining the actual audit period (At) was not possible and this prevent the generalization of the results for those companies with more than 13 years of cooperation with auditor.

Suggestions for future researches:

- Using prediction EPS error rate as a criterion for evaluating the quality of financial statements and investigating its relationship with audit time.
- Conducting a study on the impact of duration of connection with partner signing the audit report and audit quality. For example, in some countries such as U.S. and Australia, instead of obligatory changing of audit institutions, it is suggested to change the partner signs the report after 5 years. Such a research can clarify the fashion this variable affect audit quality.
- Conducting a study on the fashion of audit time effect and the type of statement can clarify the effect of this issue on the actual quality of audit reports.
- Investigating non-economic factors such as political factors in mandatory selection of auditing institutions for some public companies or institutions in Iran and the impact of this issue on the quality of financial statements of mentioned companies and institutions.

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