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AUDITORS TENURE AND FINANCIAL REPORTING QUALITY: EVIDENCE FROM A DEVELOPING COUNTRY

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ABSTRACT

The purpose of this paper is to examine the relationship between audit firm tenure and financial reporting quality. Particularly, this study examines whether firms with longer audit firm tenures are more engaged in accrual-based earnings management activities in Pakistani. Current study measures auditor tenure as the number of consecutive years that the client has retained the audit firm. This study selected sample data from 280 non-financial listed firms in Pakistan Stock Exchange (PSE) during the period of 2008-2017, which comprise of 2,800 firm-year observations. The results exemplify that firms with longer audit firm tenures are more negatively associated with accrual-based earnings management activities, and showing better financial reporting quality. Moreover, the study shows that non-mandatory audit firm rotation is associated with accrual-based earnings management activities, and showing poor financial reporting quality. Apparently, the study implies that there is an adverse relationship between auditor tenure and financial reporting quality, pursuant to which the regulators must keep non-mandatory auditor rotation factor in mind during regulatory reforms. This study contributes to the field of corporate governance where it integrates auditor firm tenures with financial reporting quality. Further, this study contributes to practice where it provides deep insight to policymakers who are interested in improving corporate governance in transnational economies.

Contribution/ Originality: This study contributes to the existing literature by examining the relationship between audit firm tenure and financial reporting quality in Pakistan. This study contributes to the existing literature by showing that longer audit firm tenure is negatively associated with accrual-based earnings management activities and showing better financial reporting quality.

1. INTRODUCTION

Audits is progressively an essential link in the financial reporting because it helps to assure the integrity of capital markets and protecting investors, creditors, government agencies, etc. These stakeholders worldwide rely on auditors to check and confirm the reported financial information to make well-informed decisions. Hence, the audit is the examination of the financial report of a firm by an independent body. Despite Audit reports and oversight, financial scandals upsurge that impedes investors confident, hence the need for a quality audit.

The recent accounting scandals of Tesco, Patisserie Holdings, and British Telecommunications have raised regulatory bodies and authorities concerns about financial reporting quality and auditor independence. These accounting scandals raised public concerns that financial reporting quality needs further scrutiny. Prior studies found that auditor tenure is one of the main factors that may affect auditor independence because of auditor compromises on their client's reporting choices in order to retain a long-term auditor-client relationship. Consequently, long auditor tenure negatively affects financial reporting quality. On the contrary, auditor rotations are likely to improve auditor independence, and consequently improves financial reporting quality. In contrast, some researchers (El Guindy and Basuony, 2018) argue that auditors have better knowledge and experience to determine whether the firm's reporting choices are proper when they audit the same firm over time.

Prior studies use accrual-based earnings management as a measure of financial reporting quality and empirically investigate the relationship between auditor tenure and accrual-based earnings management activities. For example, Al-Thuneibat *et al.* (2011) and Johnson *et al.* (2002) show that short audit firm tenure is linked to a higher level of accrual-based earnings management activities as compared to medium audit firm tenures. However, they find no relationship between longer audit firm tenures and accrual-based earnings management activities. Similarly, using the accrual–cash flow measure of conservatism, Rickett *et al.* (2016) found that auditor tenure may have a negative impact on audit quality and auditor independence, suggesting poor financial reporting quality. On the contrary, Malik *et al.* (2017); Hohenfels (2016) and Ghosh and Moon (2003) exemplify a negative relationship between longer audit firm tenures and accrual-based earnings management, implying that longer audit firm tenures are linked with better financial reporting quality. Therefore, there is no consensus on whether longer audit firm tenures are associated with higher/lower accrual-based earnings management activities.

After the occurrence of accounting scandals in the last decade, the Sarbanes-Oxley Act of 2002 requires mandatory rotation of audit firms at least once every five years. Several other countries also have similar requirements for mandatory rotation of audit firms. However, there are no such requirements of mandatory rotation of audit firm tenures in Pakistan. Therefore, in the current study, the determinants of financial reporting quality are further examined to understand the impact of auditor tenure. Particularly, this study provides a detail explanation on the association between audit firm tenure and accrual-based earnings management activities in a single country, like Pakistan. The results are also useful for regulators to monitor any earnings management activities. Congruent with prior studies (Malik *et al.*, 2017; El Guindy and Basuony, 2018) the findings of this study suggest that longer audit firm tenures improves the audit quality and financial reporting quality of the firm. Considering the negative impacts of non-mandatory audit firm rotation on financial reporting quality, this study has implications for regulatory bodies and policy-makers in emerging economies, particularly in Pakistan. The regulatory bodies should require the firms not to do the non-mandatory audit firm rotation.

The remainder of this paper is structured in such a way that there is a hypotheses development, followed by data and methodology, results and conclusion in the end.

2. HYPOTHESIS DEVELOPMENT

2.1. Auditor Tenure and Financial Reporting Quality

Mandatory audit firm rotation is the change of audit firm with the objective to avoid the close relationship between auditor and clients that could lead to accounting misstatements and frauds. The rotation occurs in several ways: first, firms can voluntarily rotate their auditor however, reasons for this form of rotation is ambiguous as such information are not disclosed by firms. Nashwa (2004) study shows that voluntary change of auditors is frequently linked to audit failures like fraud, financial distress, shareholder's discretion and auditor ineffectiveness (Malik *et al.*, 2017). Second, mandatory rotation for an Audit firm, which requires the firm to end the tenure with its current auditor after a certain number of years. This rotation of the audit firm has both positive and negative impact on financial reporting quality (Monroe and Hossain, 2013).

Prior studies link long tenure of an audit firm to the independence of the auditor; some studies even show that rotation is mandatory to promote independence. Other studies show that audit rotation create independence but do not improve financial reporting quality rather increases audit cost (Adeniyi *et al.*, 2013) because audit firm may have limited information of new client which may consequently lead to lower audit quality (Firth *et al.*, 2012; Bowlin *et al.*, 2015).

However, Myers *et al.* (2003) claimed that long auditor tenure negatively affect audit quality, weaken auditor's independence and objectivity (Luippold *et al.*, 2015) and lack of auditor's independence would encourage earnings management and creative accounting practices, because due to longer auditor tenure the auditors are closely linked to the management. Therefore, protect the stakes of management instead of stakeholders.

H1: There is a significant negative relationship between auditor tenure and accrual-based earnings management activities.

3. DATA AND METHODOLOGY

This study selected sample data from 280 non-financial listed firms in Pakistan Stock Exchange (PSE) during the period of 2008-2017, which comprise of 2,800 firm-year observations. The author(s) collected panel data set manually from the annual reports of the sample firms. Congruent with prior studies, all listed financial firms are excluded from the sample, because of the strict regulatory environment in these sectors, thus it is inappropriate to estimate accruals quality for such firms (Sadiq and Othman, 2017).

3.1. Measurement of Financial Reporting Quality

Our estimation model uses accruals quality to signify financial reporting quality. In general, if current accruals closely mapped into cash flows then it suggests less involvement of firms in accrual-based earnings management activities and better financial reporting quality and vice versa (Chaney *et al.*, 2011; Sadiq and Othman, 2017). Accruals quality has been widely used as a proxy of accruals-based earnings management and financial reporting quality in previous research (Dechow *et al.*, 2010).

Dechow and Dichev (2002) introduced the accruals quality model in two steps. First, current accruals were mapped into operating cash flows to estimate non-discretionary accruals. Second, accruals quality is determined via the estimate of the error term in the model. Thus, the error term equals to the difference between operating cash flows and total current accruals, which represents accruals quality. The higher the difference between operating cash flows and total current accruals the lower the quality of accruals and vice versa (Dechow and Dichev, 2002):

$$TCACC_{i,t} = \alpha_0 + \alpha_1 OCF_{i,t-1} + \alpha_2 OCF_{i,t} + \alpha_3 OCF_{i,t+1} + \mu_{i,t} \qquad 1$$

Where; the error term in the above Equation 1 shows the extent to which the total current accruals map into explanatory variables (i.e. lagged, current and lead operating cash flows), and the standard deviation obtained from this regression is a proxy for accruals quality. All variables are scaled by lagged total assets.

3.2. Auditor Tenure

We measure auditor tenure as the number of consecutive years that the client has retained the audit firm.

3.3. Estimation Model

While examining the relationship between auditor tenure and financial reporting quality, this study includes several control variables, which were used in previous studies (Al-Dhamari and Ku, 2015; Braam *et al.*, 2015; Sadiq and Othman, 2017). We have included financial leverage (LEV), firm size (SIZE), audit quality (BIG4), and growth opportunities (GROWTH) to separate other factors that may influence financial reporting quality.

To test our hypothesis, we used Panel Corrected Standard Error (PCSE). It is the appropriate method to use when there is an issue of heteroscedasticity. Thus, the current study used PCSE technique to test the following regression:

$$FRQ_{i,t} = \delta_0 + \delta_1 ATenure_{i,t} + \delta_2 SIZE_{i,t} + \delta_3 LEV_{i,t} + \delta_4 GROWTH_{i,t} + \delta_5 BIG4_{i,t} + \delta_6 Industry_{i,t} + \mu_{i,t} \quad 2$$

Where, FRQ represents financial reporting quality of firm i in year t; ATenure represents the number of consecutive years that the client has retained the audit firm; SIZE represents the total assets of firm i in year t; LEV represents the financial leverage of firm i in year t, GROWTH represents the change in sales volume of firm i in year t; and BIG4 represents the audit quality of firm i in year t.

4. RESULTS

Table 1 reports descriptive statistics for the dependent and independent variables over the period 2008–2017. AEM has a mean value of 0.0872, with the minimum value -1.7268 and maximum value 2.4568. The mean value of ATenure is 4.68, with the minimum audit tenure of 1 year and maximum of 9 years. LEV has a mean value of 0.6285, with the minimum value 0.0355 and maximum value 3.7822. SIZE has a mean value of 6.8580, with the minimum value 4.7308 and maximum value 8.6270. Growth has a mean value of 0.1640, with the minimum value of -1.4684 and maximum value 7.8808. BIG4 has a mean of 0.41 suggesting that 41% of the sample firms are audited by big four auditors.

Table-1. Summary Statistics of the variables used in analysis.

Variable	Observations	Mean	Min	Max
AEM	2800	0.0872	-1.7268	2.4568
ATenure	2800	4.68	1	9
LEV	2800	0.6285	0.0355	3.7822
SIZE	2800	6.8580	4.7308	8.6270
Growth	2800	0.1640	-1.4684	7.8808
BIG4	2800	0.4100	0	1

Note: All variables are explained in Table 4.

Pearson correlation is presented in Table 2. The low correlation between independent variables signifies that there is no serious multi-collinearity problem in the data set. Consistent with our hypothesis, there is a significant and negative correlation between auditor tenure and accrual-based earnings management activities, suggesting that firms audited by the same auditor for a longer period are less engaged in accrual-based earnings management activities, and therefore, show better financial reporting quality and accruals quality.

Table-2. Pearson Correlations of the accruals earnings management and independent variables.

Variable	AEM	ATenure	Growth	BIG4	SIZE	LEV
AEM	1					
ATenure	-0.0008*	1				
Growth	0.11*	0.001	1			
BIG4	0.23**	-0.16*	0.19**	1		
SIZE	0.112	0.135*	0.105*	0.502***	1	
LEV	-0.07*	0.255***	-0.165**	-0.307***	-0.114*	1

Note: All variables are explained in Table 4.
* Correlation is significant at the 0.10 level.
** Correlation is significant at the 0.05 level.
*** Correlation is significant at the 0.01 level.

4.1. Regression Results

In Table 3, the results show the negative and significant relationship between auditor tenure (ATenure) and accrual-based earnings management activities (AEM), suggesting that increase in audit firm tenures lead to a better financial reporting quality and vice versa. The findings are consistent with the findings of Malik *et al.* (2017); Hohenfels (2016) and Onwuchekwa *et al.* (2012) who suggest that firms longer auditor tenure are more inclined to report better financial reporting quality and less involved in accrual earnings management activities. This is because: in a longer client-auditor relationship, auditors have better client information and possess required client-specific knowledge. Moreover, our results are also consistent with the findings of previous studies (El Guindy and Basuony, 2018) which suggest that longer audit firm tenure does not affect auditor independence but in fact improves the quality of audit and financial reporting quality. Contradictory to the findings of Mgbame *et al.* (2012) we argue that without mandatory auditor rotation and frequent auditor rotations may negatively affect auditor independence, and consequently affects audit quality and financial reporting quality.

Congruent with the study of Braam *et al.* (2015) GROWTH is negatively and significantly associated with AEM, signifying that high growth firms are less involved in AEM and reporting better financial reporting. This is because; high growth firms are expected to be better performing firms, and therefore, they have fewer incentives to get involved in accrual-based earnings management to achieve target earnings. In line with the study of Sadiq and Othman (2017) BIG4 is negatively and significantly related to AEM, indicating that firms audited by big four auditors have better financial reporting quality as compared to firms audited by non-big four auditors. It implies that big four audit firms have curtailed AEM activities in firms. In addition, SIZE is positively and significantly associated with AEM, suggesting that large size firms are more involved in AEM activities and show poor financial reporting quality. LEV is positively and significantly associated with AEM, implying that firms with high debt ratios are more engaged in AEM activities and show poor financial reporting quality. It suggests that high leverage firms may show better firm performance through accrual-based earnings management activities with the objective to improve their credit ratings.

Table-3. Linear results of the relationships between audit tenure and accruals earnings management.

AEM	Coefficient	z	P>z
ATenure	-0.0029	-3.01	0.004
GROWTH	-0.4760	-3.11	0.002
BIG4	-0.0302	-1.98	0.047
LEV	0.1192	4.59	0.000
SIZE	0.0422	1.8	0.072
Industry Effect		Yes	
R-Square		0.1898	
Observations		2800	

Note: All variables are explained in Table 4.

5. CONCLUSION

Congruent with hypothesis 1 and previous literature, this study finds that firms with longer audit firm tenures have less involvement in accrual-based earnings management activities (Malik *et al.*, 2017; El Guindy and Basuony, 2018). This implies that longer audit firm tenures improve the audit quality and financial reporting quality of the firm. Considering the negative impacts of non-mandatory auditor rotation on financial reporting quality, this study has implications for regulatory bodies and policy-makers in emerging economies, particularly in Pakistan. The regulatory bodies should require the firms not to do the non-mandatory audit firm rotation. The findings of the current study cannot be generalized, because of differences in the regulatory environment and other country-specific factors, although the audit firm tenure and financial reporting quality is still a common trend in emerging economies. Future research can investigate the relationship between auditor tenure and corporate governance practices in Pakistan.

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Table-4. Definition of Variables.

Variable	Definition
$TCACC_{i,t}$	Total current accrual in year t of firm i.
OCF	Operating cash flows.
SIZE	Natural log of total assets.
BIG4	Dummy variable which is coded 1 if a firm is audited by top big four audit firms, and 0 otherwise.
LEV	Total debt to total assets.
GROWTH	Percentage change in the sales of the present year in comparison to the sales of the previous year.
$FRQ_{i,t}$	Financial Reporting Quality.
$ATenure_{i,t}$	The number of consecutive years that the client has retained the audit firm
AEM	Accruals earnings management activities, which is calculated using Dechow and Dichev (2002) Model

Self-generated