Research Journal of Finance and Accounting www.iiste.org
ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online)
Vol.6, No.1, 2015

The Impact of Auditor's Tenure on Quality Audit Report

IKHARO C.O.
Address: Department of Accountancy,Federal Polytechnic, Auchi, Nigeria
Email: chrisoikharo@gmail.com

Abstract
This research work considers the impact of Auditor's tenure on quality of audit report. There have been divergent views from previous researchers. On one hand, the first school of thought is of the view that as the tenures of the auditors become longer, they gain expertise of the businesses of their clients and therefore, their ability to detect fraud increases; conversely, the ability of the manager to commit fraud reduces. On the other hand, the contrary view is that long audit tenureship may bring about increased familiarity between the auditor and the managers. Consequently, the auditor may become more sympathetic with the management. This may in turn reduce the readiness of the auditor to qualify his report; and therefore increasing the client's fraud incentives. The impact of auditor's tenure on quality of audit report depends on his ability or the level of his independence. The contributions of previous researchers were accessed. The study suggests ; a period of one to three years as an ideal audit tenure, regular change of audit team (where necessary), review of statutory and professional provisions etc.
Keywords; Auditors Tenure, Fraud, Audit Report and Auditor's Independence.

Introduction

In view of recent corporate scandals, auditor's tenure, and independence have taken the centre stage of discussions. Opinions are centered on whether the auditee should replace its auditor on a regular basis or whether the auditor should be allowed to build a long- term relationship with the client.

According to those who are in favour of long-term relationship between the auditor and auditee, long-term relationship would allow the auditor to gain expertise of the operations of his client and therefore makes the auditor to be more efficient. It enhances the ability of the auditor to detect irregularities. On the other hand, the proponents of regular replacement of auditor are of the view that long-term auditor/auditee relationship may result in empathy between the auditor and auditee and would therefore lead to loss of auditor's independence. Loss of auditor independence may consequently result in poor quality of audit report as the auditor may disregard certain due-diligence and misconduct by management or staff.

Fairchild (2008) says "the auditor's fraud-detecting ability is positively related to tenure, implying that increasing tenure reduces managerial fraud-incentives. However, an increase in tenure may also result in a reduction in auditor independence, and an increase in auditor empathy towards the manager, implying that increasing tenure may increase fraud incentives. According to Asthana, Balsam, & Krishnan,(2007), "The financial scandal surrounding the collapse of Enron caused erosion in the reputation of its auditors, Andersen, leading concerns about Andersen's ability to continue in existence and ultimately its demise". On their part, Chaney,& Pilipich,(2002:1221-1245) say that the disclosures about Andersen caused a decline in its reputation and Andersen's clients suffered significant loss of market value.

Literature Review

As a result of recent policy debate on mandatory auditor rotation, there has been an increasing research focus on audit tenure, fraud and quality of audit.

According to Mantz and Sharaf (1981), Lyer and Rama (2004), there has long been concern that the duration of relationship between the auditor and client potentially affects audit quality, but contains conflicting arguments.

Geiger and Raghumandan (2002) test the relationship between auditor tenure and audit reporting failure using a sample of US companies entering bankruptcy. They opine that there is a negative relationship between auditor tenure and audit failures.

On the other hand, Carey and Sumnett (2006) Say that there is a positive relationship between auditor tenure and audit failure in Australia. This means that as auditor tenure increases, the auditor's ability to detect fraud reduces.

Marnet (2004) discusses how auditor independence may be compromised by self-serving biases. For instance, an auditor who had earlier issued an unqualified report may be confronted with a subsequent psychological pressures to self-justify his earlier opinion.

On his part, Fairchild (2008) using a game theory concludes that the auditor,s ability to detect fraud increases with auditor,s tenure. That is, as auditor's tenure increases, his fraud detecting efforts increase and therefore, the chances of fraud detection and probability of qualified audits increases. He is also of the opinion that as the auditor's tenure increases, managerial fraud incentive drop, thereby giving rise to reduction in managerial fraud and qualified audit reports.

According to Fairchild (2008) 'beyond a critical level of tenure, the auditor becomes sympathetic towards the manager, and she reduces fraud-detecting efforts. This results in reduction in qualified audits and an increase in fraud'. Carcello & Nagy (2004) says that;

> rotation of auditors would also reduce any financial incentives for external auditors to compromise their judgment on borderline accounting issues in disagreeing with management and auditors would no longer be risking a stream of revenues that they believed would continue in 'perpetuity' since the audit engagement would no longer be perceived as permanent.

Johnson, Khurana and Reynolds (2002) are of the opinion that absolute value of unexpected accruals is higher in the early years of auditor – client relationship as compared to medium auditor's tenure, but they say that no relationship exists between absolute value of unexpected accruals and auditor's tenure when medium tenure is compared with long tenure. Carcello et al (2004) are also of the view that the probability of fraudulent reporting is highest early in the tenure of audit firms (i.e.the first three years). Hamilton, Ruddock, Stokes, and Taylor (2005) opine ,"in contrast to the existing evidence, our paper provides support for the view that audit partner rotation is associated with a reduction in relatively aggressive accounting……."

Ghosh and Moon (2005) find that absolute discretionary accruals and the use of large negative special items to manage earnings decline with auditor's tenure.

Davis, Soo and Trompeter (2003), Casterella, Knechel and Walker (2002) opine that audit quality is lower given a longer auditor's tenure.

Davis et al (2003), declare that discretionary accruals increase with auditor's tenure and conclude that management gains additional reporting flexibility as auditor's tenure increases.

> On his part, Hills (2002) states that forcing a change of auditors can only lower the quality of audits and increase their costs. The longer an auditor is with a company' the more it learns about its personnel, its business and its intrinsic values. To change every several years will simply create a merry-go-round of mediocrity.

Fraud

Fraud has been identified as a significant problem endemic both in the public and private sectors of any nation's economy. The effects of fraud include premature termination of employments, court cases, liquidation of business entities or corporate failures and very serious negative financial impact on the economy. While many business organizations are yet to recover from the Envon's experience, the Cadbury debacle that saw the exit of the key players (like the group Managing Director, the group Financial Director, the External auditors; to mention but few) has further called for regular review of relevant statutory provisions and professional pronouncements; and ensuring that they are strictly complied with.

Gupta(2005) defines fraud as 'intentional misrepresentation of financial information by one or more individuals among persons charged with governance (e.g. board of directors and audit committee in the case of a company), management, employees or third parties.

Messier (2000:153) describes fraud as 'intentional misstatements that include management fraud and defalcation".

Oxford Advanced learner's dictionary 6th edition on its part defines fraud as the crime of deceiving somebody in order to get money or goods illegally.

Fraud is a deliberate or intentional act by a privileged individual or a group of individuals working in concert which gives rise to a financial misstatement. Where the act giving rise to a financial misstatement is intentional, it is referred to as 'fraud'. Fraud therefore is a willful act with the intent to misappropriate assets or misrepresent facts in the financial statements.

Misappropriation of assets is also referred to as 'defalcation'. Examples of such fraud include; theft of entity's assets, teaming and lading or carry over fraud , inclusion of dummy names (non-existence staff) in pay-roll, overstating amount payable on pay-roll,deliberate use of wrong salary scale ,embezzlement of unclaimed wages , illegal sale of scraps ,over invoicing of contract, illegal withdrawal of materials from store for fictitious repairs or maintenance etc.

Fraudulent financial reporting does not involve misappropriation of the entity's assets. It is perpetrated usually; by management in order to enable it accomplish it's aims. The aim may be to deceive the users of financial statements to make a wrong decisions.

Therefore, fraudulent financial reporting is usually done to further the goals of the management; such as presenting a better profit profile. Though the immediate intention is not to better the lot of the employees, where it involves overstating the turnover or profit (for example), it may cause the entity to pay a higher bonuses, incentives or dividends.

Examples of fraudulent financial statements include; understating expenses by capitalizing costs that should have been expensed, overstating turnover by recognizing revenues before they are earned, failure to provide for bad and doubtful debts, overstating assets, understating liabilities, disclosures not adequately made in the account etc.

Fraud Detection

Fraud detection refers to discovering of fraud that has made the financial statement to be misrepresented. Detection of fraud can be facilitated by installation and full implementation of an adequate system of internal controls.

According to Gupta (2005), persons charged with governance are those that are entrusted with the supervision, direction and control of an entity and are thus accountable for ensuring that the entity achieves its objectives. They monitor the overall effectiveness and integrity of entity's accounting and internal control systems and ensure the entity's compliance with legal and regulatory framework. The management of the entity (chief executive officer and his team) is required to establish and implement appropriate controls and ensure their continued and effective operation.

Responsibility of the Auditor to Detect Fraud and Errors

It is not the primary duty of the auditor to detect fraud and errors. Generally Accepted Auditing Standards (GAAS) require the auditor to plan and perform his work with due professional care, skill and diligence. The application of due professional care enables the auditor to obtain reasonable assurance that the financial statement is free from material misstatements.

When ever the auditor's suspicion is aroused, he is expected to carry out such tests that would enable him to obtain reasonable assurance that there are no material misstatements in the accounts.

Note that where there is concealment of fraud through falsification of documents or/and collusion, a properly planned and executed audit may not detect material frauds. Therefore auditor's opinion does not guarantee that the financial statement is free from material misstatements. And the fact that there are material misstatements (errors or frauds) in the financial statements does not mean that the auditor had; failed to obtain reasonable assurance, not applied due professional care, failed to comply with generally accepted auditing standards, or not adequately planned, performed or made his audit opinion.

Audit Report

According to Messier (2000:55), "Audit report is the main product or output of the audit". Gupta (2005:582) describes audit report as 'the end product of every audit. He says that it is the medium through which an auditor expresses his opinion on the financial statements or other prepositions under audit.

The report communicates the auditor's findings to the users of the financial statement. It is the culmination of a process of collecting and evaluating sufficient competent evidence concerning the fair presentation of the management's assertions in the financial statements. The audit report adds value to the financial statements because of the auditor's objective and independent opinion on the fairness of the financial statements.

The report is required to state whether the financial statements are presented in accordance with the Generally Accepted Accounting Principles (GAAP).

According to O'Reilly, Mcdonnell, Winograd, Gerson and Jaenicke (1998:28.8), Generally Accepted Accounting Principles provide a consistent frame of reference against which each management's assertions that are implicit in the financial statements can be evaluated.

The Generally Accepted Auditing Standards (GAAS) require the auditor to plan and execute his work with due professional care, skill and diligence. According to O'Reilly et al (1998:4.5), due professional care, in turn requires the auditor to exercise professional skepticism.

The exercise of due care enables the auditor to obtain reasonable assurance that financial statements are free from material misstatement. When fraud is detected (whether material or immaterial), the auditor is expected to consider the implications for the integrity of the entity's employees (and particularly the integrity of the management) and the possible effect on other aspects of the audit and report accordingly.

SAS number 99 requires auditors to overcome some natural tendencies such as over reliance on the client's representations and biases, and approach the audit with skeptical attitude and questioning mind. The auditor is also required to set aside past relationships and not assume that all clients are honest. The standard provides suggestions on how auditors can learn how to adopt a more critical, skeptical mind-set on their engagements, particularly during audit planning and the evaluation of audit evidence.

According to Ramos (2003), the mere fact that the engagement team has a serious discussion about the entity's susceptibility to fraud also serves to remind auditor's the possibility does exist in every engagement in spite of any history or preconceived biases about management's honesty and integrity.

Auditor's Independence

Izedonmi (2000:83) opines that "Auditor's independence implies the ability of an auditor to perform his audit work in accordance to his judgment, free from any undue influence and without being biased". Independence is an attitude of mind characterized by integrity and objectivity. An auditor should not only be independent but he should also be seen as being independent. An auditor is expected to avoid undue influence. He should be independent in planning his work, in carrying out his work and in reporting his opinion in respect of the financial statements. In other words, the auditor should be free from any influence or interference in the planning and conduct of his work and he should be objective in reporting his opinion without fear of the management, staff, shareholders or any other stakeholder for that matter.

Independence is an important attribute of an auditor. The auditor needs to be independent of everyone who has contact with the business of his client. An auditor cannot be objective unless he is independent of all persons. The auditor's independence must be beyond question. He should be seen to be independent by all.

Objectivity is a state of mind that is characterized by the fulfillment of professional and legal obligations without compromising ethical beliefs or yielding to the demands of other persons. In other words, objectivity helps to ensure respect for rule of law and maintenance of professional integrity. It also helps in satisfying the expectation of the client and the public at large.

Integrity is an essential quality of an auditor or any professional. Iyoha (2005:13) defines integrity as "the aspect of one's character rooted in his conviction which serves to deter him from taking advantage of his position or strength to gain at the expense of his organization, customer, client or subordinate". A person of integrity should be honest, truthful and fair in all his dealings.

The overall rule of professional conduct is that an accountant must always approach his work with integrity and objectivity. He must approach his work in a spirit of independence of mind.

Integrity implies honesty. Both words are used interchangeably. According to Aguolo (2006), where as honesty connotes telling the truth, integrity implies keeping faith even when there is scope and opportunity to default without consequence. According to him, honesty is enforced value while integrity is a trait acquired as a result of upbringing, training or association. He says, honesty propels the individual to keep the rules for fear of being exposed and probably face the consequences, integrity propels the individual to keep the rules even when he is sure that no one is watching and in fact there is no chance of being detected. An honest person always looks out for loopholes in the laws and exploits them where they exist, but a person of integrity does not bother to exploit loopholes in the law.

Threats to Auditor's Independence

Certain factors pose threats to independence of the auditors. In other words, these factors impair the independence of the auditors. Some of these factors are: familiarity threat, fear of being fired, shareholdings in client company, loans to or from client, hospitality, auditor acting as a trustee, mutual business interest, participation in the affairs of a client, litigation, etc.

Rules of Professional Conduct to Ensure Auditors Independence

These rules serve as guidance to the accountant in the conduct of his work and they relate to; Fees, Personal Relationships, Beneficial shareholding, Loans to and from clients, Acceptance of Goods or Services from a client, Commission, Dealings with clients' monies, Provision of other services, Officer or staff of the client should not take part in the audit, Where a partner or an audit staff of a member is an officer of the client, Receivership, Liquidation and auditors, A member should not accept or perform work which he or she is not competent to undertake unless he or she obtains such advice and assistance as will enable him or her to competently carryout the work, A member should carryout his or her work with due skill, care, diligence and expectation and with proper regard for technical and professional standards expected of him as a member, A firm should not accept a prospective audit where a partner or staff (or person closely connected to them) acts as a trustee of a trust; Which holds more than 10% of the shares of the prospective entity or Whose investment in the prospective client entity exceeds 10% of its total assets, A firm should not audit financial statements that include the product of specialist valuation by the firm or its associates, No audit engagement partner should remain in charge of audit of a listed company for more than seven consecutive years; and at least five years must elapse before such a partner can return to the engagement, An auditor should not act for two opposing clients in respect of negotiation, settlement of claims unless the two clients have agreed that he should act as an arbitrator, A practice should not accept an audit where the fees will be based and payable on the successful completion of the audit etc.

CAMA 1990 Rules to Ensure Auditors' Independence

The Companies and Allied Matters Act (CAMA) 1990 as amended made provisions that are expected to ensure the independence of the auditors. These provisions centre on appointment of auditor, disqualification of the auditor, remuneration of the auditor, rights of the auditor and removal of the auditor.

Conclusion and Recommendations.

The length of auditor's relationship with his client is an important factor to be considered when the causes of fraud or/ and the quality audit report are being determined.

Auditor's tenure impacts directly on fraud commission and quality of audit report. From the study, it is observed that as the tenure of the auditor gets longer, the relationship of the staff of both the auditor and the client gets more intimate or cordial. This situation impairs the independence and objectivity of the auditor. Chances are that the auditor may over look certain activities of the client's staff which should have being investigated under normal circumstances. As a result of this, the fraud incentive for the client's staff is being enhanced.

On the other hand, as the auditor's tenure becomes longer, he knows more about the operations and the accounting system of the client. Under this situation, the ability of the auditor to detect fraud is enhanced. Therefore, the quality of audit report is improved.

In order to achieve an adequate result, there is need to moderate the length of auditor's tenure. This is the reason for the agitation for rotation of auditors or members of audit team. The study suggests an audit tenure of between one and three years. However it may be necessary to strike a balance between fraud prevention and quality of audit report.

References

Agulo, O. (2006), *Ethics and Integrity in the Accounting Profession*, The Nigerian Accountants, October/December.

Asthana, S, Balsam,S and Krisnan,J;(2007) , *Audit Firm Reputation, Auditor Switches and Client Stock Price Reactions: The Andersen Experience.*

Chaney,P.K.and Philipich,K.L.(2002): *Shredded Reputation: The Cost of Audit Failure*. Journal of Accounting Research 40 (Sept): 1221-1245.

Carcello J.V. and Nagy A.L.(2004): *Audit Firm Tenure and Fraudulent Financial Reporting.*

Carey, P and Sumnett, R (2006): *Audit Partner Tenure and Quality*, The Accounting Review Vol. 81. No. 3 Pp 653-676

Casterella J, Knechel, W.R. and Walker, P.L (2002): *The Relationships of Audit Failures and Auditor Tenure*, Working Paper, University of Florida.

Companies and Allied Matters Act (CAMA) 1990.

Davis, I.R, Soo, B and Trompeter, G (2003): *Auditor Tenure, Auditor Independence and Earnings Management, Working Paper*, Boston college, Boston, M.A.

Fairchild, R (2008): *Auditor Tenure, Managerial Fraud and Report Qualification: A Behavioural Game-Theoretic Approach,* Int. J. Behavioural Accounting and Finance, Vol. 1 No. 1 pp 23-37

Geiger, M.A and Raghumandan, K (2002): *Auditor Tenure and Audit Reporting Failures,* Auditing: A Journal of Practice and Theory 21 (1) (March).

Ghosh, A and Moon, D (2005): "Does Audit Tenure Impair Audit Quality?", The Accounting Report Review, April, Vol. 80 PP 585-612

Gupta, K,(2005): *Contemporary Auditing*, 6th edition, New Delhi,McGraw Hill Publishing Company Limited.

Hamilton,J, Ruddock,C, Stokes,D and Taylor,S(2005): *Audit Partner Rotation, Earnings Conservatism.*

Hansen,J.W. (2007): *Academics Dictionary of Accounting* New Delhi, Academic (India) Publishers.

Hills, R.M.(2002), *Oversight Hearing On Accounting And Investor Protection, Issues Raised By Enron And Other Public Companies*.

Iyoha, F.O. (2005). *Expectation of the public from the Institute of Chartered Accountants of Nigeria*, Being a paper presented at the 40th Anniversary of the Institute.

Izedonmi, F. (2000), *Introduction of Auditing*, Benin City, Ambik Press, 1st Edition.

Johnson, V.E, Khurana, I.K and Reynolds, J.K. (2002): *Audit Firm Tenure and Quality of Financial Reports*, Contemporary Accounting Research (Winter): 637-660

Marnet, O (2004): *Behavioural Aspects of Corporate Governance*, Corporate Governance: Advances in Financial Economics, vol. 9. Pp 265-285

Messier, W.F. (2000): *Auditing and Assurance Services: A Systematic Approach* , USA, McGraw-Hill Higher Education 2nd edition.

O'Reilly, V.M, McDonnell, P.J, Winograd, B.N, Gerson, J.S, and Jaenicke, H.R (1998), *Montgomery's Auditing*, Canada, John Wiley & Sons Inc. 12th edition.

Oxford Advance Learners Dictionary 6th edition.
Ramos, M,(2003) *Auditor's Responsibility for Fraud Detection*, http://www.aicpa.org/pubs/jofa/Jan2003/ramos.htm

The IISTE is a pioneer in the Open-Access hosting service and academic event management. The aim of the firm is Accelerating Global Knowledge Sharing.

More information about the firm can be found on the homepage:
http://www.iiste.org

CALL FOR JOURNAL PAPERS

There are more than 30 peer-reviewed academic journals hosted under the hosting platform.

Prospective authors of journals can find the submission instruction on the following page: http://www.iiste.org/journals/ All the journals articles are available online to the readers all over the world without financial, legal, or technical barriers other than those inseparable from gaining access to the internet itself. Paper version of the journals is also available upon request of readers and authors.

MORE RESOURCES

Book publication information: http://www.iiste.org/book/

Academic conference: http://www.iiste.org/conference/upcoming-conferences-call-for-paper/

IISTE Knowledge Sharing Partners

EBSCO, Index Copernicus, Ulrich's Periodicals Directory, JournalTOCS, PKP Open Archives Harvester, Bielefeld Academic Search Engine, Elektronische Zeitschriftenbibliothek EZB, Open J-Gate, OCLC WorldCat, Universe Digtial Library , NewJour, Google Scholar