



Assessing the Effects of Auditing Institutions' Size and Type of Auditors' Opinion on Auditing Institutions' Rotation

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ABSTRACT: Nowadays, not only in academic areas but also among the ordinary people and organizations, auditors' independency is receiving increased attention which brought up the discussion of obligatory auditors' rotation. Considering the significance of this issue, the current study aimed to investigate some effective factors in auditing institutions' rotation. Therefore, the effects of "the type of auditors' opinion" and "auditing institutions' size" on "auditing institutions' rotation" were assessed in this research. Target population of the study was consisting of 110 listed companies on Tehran stock exchange which had experienced the auditing institution's rotation at least once, over a 5-year-period, from 2007 to 2011. The obtained findings indicated that the type of auditors' opinion and auditing institutions' size are not significantly associated with auditing institutions' rotation.

Key words: Auditing Institution's Rotation, The Type of Auditor's Opinion, Auditing Institution's Size

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INTRODUCTION

The expansion of economic units, information technology and conflicting interests have caused supervisory needs. Globalization of world market, economics and information revolution are all beyond the government's control. Much information about economic organizations is needed to be able to make decision. Conflicting interests have made it considerably difficult to rely on the collected data. Not having direct access to the required information, besides conflicting interests, have increased the necessity of auditor independence. In fact, auditors evaluate the level of information quality to offer to the users.

The Enron scandal, revealed in October 2001 in the United States, the Parmalat scandal in Europe, and net baking fraud cases in Iran or other financial crises have all challenged auditors and auditing quality. Politicians have considered efficient auditing as a key factor to improve auditing quality and auditor independence. The most valuable property of auditors can be their independence. As a matter of face, auditors are capable of earning if they are reliable enough to be free to approach a piece of work in whatever manner they consider best.

Therefore, many solutions have been suggested by experts and authorities in order to enhance the quality of audit reports and auditing organizations' independence. They mostly stated that the public companies should be required and forced to automatically change or rotate their independent auditing firms. To further enhance independence, The Sarbanes-Oxley Act (SOX) calls for the mandatory rotation of the lead engagement partner every five years (NavaeiLavassani et al. 2012). In Iran, by virtue of

paragraph 2, clause 10 ratified on July 30, 2007 by auditing organizations trusted by listed companies on Tehran stock exchange, auditing firms or the lead engagement partners must be changed after 4 years, and by law they cannot be again the independent auditor or the controller of the same legal person.

The importance of auditing institutions has made the researcher appraise auditing institutions' rotation, so the effects of the type of auditors' opinion and auditing institutions' size on auditing institutions' rotation were assessed in this research among listed companies on Tehran stock exchange. Independence is the main specification of auditor independence. Ghaemi et al. 2012 regarded independence as evident condition of auditing. Enhancing auditor independence can increase the validity of financial opinion and investors.

Mandatory rotation is also recommended to develop auditor independence. Those who support the existence of mandatory rotation believe that long-term contractions between auditor and employer may be the main reason of the paucity of auditor independence. Long association between auditor and employer does not let the auditor carry out his or her work freely and in an objective manner, so the auditor may have a tendency towards the employer's viewpoints which avoids auditor independence. Furthermore, mandatory auditor rotation can make auditors resistant to the managers' pressure and requests (KarbasiYazdi et al., 2012).

Chung (2004) concluded that mandatory rotation can enhance auditor independence. On the other hand, Depoch et al. conducted an experimental study and examined auditors' tendency to report biased opinion

which support the managers. They found that mandatory auditor rotation can improve the level of auditor independence. Some influential factors in auditing institutions' rotation are explained as follows. Auditing institutions can be generally classified into big and small institutions. Differences in these institutions' effectiveness result from the differences in their managers' stimuli to report financial opinion. When managers are motivated enough to increase the amount of interest by employing accounting methods, auditor independence can cause some conflicts between managers and auditors. Big auditing institutions can avoid interest manipulation more successfully and effectively than small institutions (assuming the existence of conflict between manager and auditor) (HassasYeganeh et al. 2010).

Yosef et al (2006) demonstrated that auditing quality in big institutions is considerably higher than small institutions.

Heshi et al. (2013) found that bigger institutions are more qualified to discover the momentous manipulations due to their experienced employees. Dan et al stated that bigger institutions are not concerned about losing their managers, since a large number of managers exist in these institutions; therefore, they place more emphasis on auditing in order to achieve more popularity.

Henock (2005) carried out a research and found that big institutions offer better services in proportion to small institutions. However, some small institutions provide good consultations for their employers.

Pour Behbahani (2008) concluded that there is a significant difference between auditor rotation and auditing institution's size. Wu et al. (2002) found that auditor rotation mostly occur in the organizations in which small auditing institutions had audited the data. Suyono et al. (2013) conducted a study with regard to effective elements in auditor rotation and stated that auditing institution size and auditor rotation.

First hypothesis: There is a significant relationship between auditing institution's size and auditing institution's rotation. An independent opinion, unbiased and fair, can drastically help to make decision and create an efficient market. The findings of conducted studies indicate that the paragraphs of auditing reports negatively affect stock prices, so the companies which receive qualified report are more likely to rotate their auditor (De Anglo, 1981). Wu Chun et al (2002) found that qualified opinion of auditors directly influence auditor rotation. Reza Zadeh et al. (2009) concluded that the type of auditor's opinion can be applied as a pattern to predict the firm's auditor rotation.

AghaeiChadgani et al. (2011) carried out a research which proved there is no significant

relationship between the type of auditor's opinion and auditor rotation.

Second hypothesis: There is a significant relationship between the type of auditor's opinion and auditing institution's rotation.

MATERIAL AND METHODS

A binomial test was applied to test research hypotheses. In this study, the size of audit institution and type of audit opinion as independent variables and audit institution rotation as the dependent variable are considered that are measured as follows.

Dependent variable: Auditing institution's rotation: Auditing institution's rotation stands for auditor rotation of a business firm during a period of at most four years and choosing among other qualified auditing institutions as the new auditor.

Independent variables: 1. Size of audit institution: In this study, like the other researchers conducted by Azinfar and Pour Behbahani, the discrete variables of 0 and 1 were utilized to calculate the institution's size. In other words, big auditing institution's size was considered 1, and members of big institutions were regarded as small auditing institutions which got 0.

2. Type of audit opinion: To evaluate the type of auditor's opinion, auditing reports were studied in preceding and following years of auditor rotation.

In the present study, like the studies carried out by Reza Zadehat al. (2009) discrete variables of 0 and 1 were employed to calculate the type of auditor's opinion. Number 1 was needed to accept the auditor's opinion and other opinion which got zero were rejected.

Target population of the current study was comprised of all listed companies on Tehran stock exchange from 2007 to 2011 which had the following conditions:

1. Financial year of the firm ended in March.
2. An auditor rotation has happened during the period of at most four years, and audited financial opinion were in access from 2007 to 2011.
3. They should not belong to investment companies or mediation offices, insurance companies or banks.

Considering the aforementioned conditions, 149 companies were chosen as the target population of the research. Among 149 companies, 39 companies had partner rotation, not auditor rotation, so they were omitted from research sample. Finally, 110 companies were regarded as the research sample.

RESULTS

A binomial test was applied to test research hypotheses. H0 indicates an insignificant relationship and H1 indicates a significant relationship between the variables.

$$\begin{cases} H_0 : P < p_0 \\ H_1 : P \geq p_0 \end{cases}$$

First hypothesis: There is a significant relationship between auditing institution’s size and auditing

institution’s rotation. The results of binomial test are shown in table 1 which demonstrate significance level of 0.000 (less than 0.05). Due to the fact that the proportion of findings which approve the effectiveness of auditing institution’s size in auditor rotation to the findings which do not approve this hypothesis is about 3% to 97%, this conclusion can be drawn that there no significant association between auditing institution’s size and auditing institution’s Rotation.

Table1. Results of binomial test of the first hypothesis

Correlation	Group	N	Observed proportions	Test’s proportion	Sig.
H0 (ineffective)	0.00	139	0.97	0.50	0.001
H1 (effective)	1.00	5	0.03		
Total		144	1.00		

Second hypothesis testing: There is a significant relationship between the type of auditor’s opinion and auditing institution’s rotation. The results of binomial test demonstrated in table 2 indicate the significance level of 0.001 which is less than 0.05. Owing to the fact that the proportion of findings which

approve the effectiveness of the type of auditor’s opinion in auditor rotation to the findings which do not approve this hypothesis is about 36% to 64%, this conclusion can be drawn that there no significant association between the type of auditor’s opinion and auditing institution’s rotation.

Table2. Results of binomial test of the second hypothesis

Correlation	Group	N	Observed proportions	Test’s proportion	Sig.
H0 (ineffective)	0.00	92	0.64	0.50	0.001
H1 (effective)	1.00	52	0.36		
Total	144	1.00			

DISCUSSION

The findings of this study indicate that the variables of the type of auditor’s opinion and auditing institution’s size are not significantly associated with the variable of auditing institution’s rotation. Considering the conducted researches, it can be alleged that auditor rotation is accompanied with various positive and negative effects. Some scholars have regarded auditor rotation as a positive factor due to its effects on independence enhancement and auditing quality improvement. However, some researchers counted it as a negative factor in auditing quality which increases auditing costs; therefore, it is suggested to ponder over its application.

By and large, the findings of the current study demonstrate that auditor rotation results from many known and unknown factors, and financial opinion’ users should be aware of this specification. In fact, auditor rotation ought to improve auditor independence, and authorities should codify the policies of auditor rotation in a way that unqualified and illegitimate factors cannot change auditors. According to the opinion of authorities in Tehran stock exchange and supervisory boards which observe the institutions’ financial reports in different countries, this

conclusion can be drawn that official and regular auditor rotation can help potential and actual investors to make decisions apropos of stock exchange. Delivered reports by the aforementioned authorities indicate that auditing institution’s rotation brings a positive impression of this strategy to the beneficiaries’ mind.

Regarding the results, it is recommended to pay more attention to the auditors who are certified accountants, and provide a competitive environment. An opportunity should be also given to the auditors to fill a highly specialized position. The assessment of changing the partners or the cadre of auditors in an auditing institution is suggested instead of auditing institution’s rotation. In this way, auditor independence is also retained and auditing costs decrease.

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