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Auditor tenure and audit quality in Spanish state-owned foundations



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ABSTRACT

This paper aims to analyze the impact of auditor tenure on audit quality. The research is motivated by the absence of consensus in published works, and by the scarcity of studies carried out on non-profit organizations. Using a sample of 254 audits carried out between 2003 and 2010 on Spanish state-owned foundations, we find that, although foundation audit quality decreases as tenure length increases, this quality loss does not become apparent until the sixth year of the foundation–auditor relationship, after an initial five years of improvement in quality. The empirical evidence is important for regulators and financial statement users, given that it suggests the need for the introduction of tenure-reducing measures which, at the same time, also ensure a minimum tenure period.

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Permanencia del auditor y calidad de la auditoría en las fundaciones públicas estatales

RESUMEN

Este trabajo analiza el impacto de la permanencia del auditor sobre la calidad de la auditoría en las entidades no lucrativas. Esta investigación está motivada por la ausencia de consenso en la literatura sobre esta cuestión y la escasez de estudios realizados en el sector de las entidades no lucrativas. Utilizando una muestra de 254 auditorías llevadas a cabo para el período 2003–2010 sobre fundaciones públicas estatales, observamos que, si bien la calidad de la auditoría de las fundaciones disminuye a medida que la permanencia del auditor aumenta, esta pérdida de calidad no se manifiesta hasta el sexto año de la relación fundación–auditor, ya que en los cinco primeros años la calidad aumenta. La evidencia empírica de esta relación tiene importantes implicaciones para los legisladores y los usuarios ya que sugiere la necesidad de introducir medidas que limiten la duración de la misma y, al mismo tiempo, aseguren una duración mínima.

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## 1. Introduction

Over the last few decades the relationship between auditor tenure and audit quality has been constantly debated. Even when prior research has been widespread and not completely definitive (Knechel & Vanstraelen, 2007, 113), most of it has involved in the for-profit sector, specifically publicly traded corporations. However, there has been little research done into the effect of the auditor on audit quality in non-profit organizations and that which has been done, as will be shown in the following section, has come out of research into other matters.

This study provides fresh empirical evidence which adds to the debate as it examines the effect of auditor tenure on audit quality in a single sector – non-profit making – where there is hardly any empirical evidence about this relationship.

This analysis is particularly relevant at the present time since governments are being forced by the economic recession to re-structure and rationalize a public sector which has ballooned over the last few decades with the creation of non-profit organizations to undertake certain public functions (Lohmann, 2007). Such organizations must convince the general public that their policies and systems are the right ones to guarantee appropriate management of the resources provided by taxpayers for them to carry out the activities for which they were set up (Greenlee, Fischer, Gordon, & Keating, 2007).

An audit is an instrument which inspires confidence in both external users of financial data concerning these organizations (beneficiaries, public bodies, donors) and internal users – mainly financial directors (Bellostas, Brusca, & Moneva, 2006). This is especially true when the audit opinion is unqualified.

The kind of audit opinion given not only suggests that the organization is complying with accounting regulations and is concerned about its financial management; it also becomes a major factor in identifying or preventing fraudulent activity (Bell & Zimmerman, 2007).

Audit report opinions are, nevertheless, affected by different factors which have been dealt with in a number of papers (González-Díaz, García, & López, 2013; Gosman, 1973; Ireland, 2003; Keasey, Watson, & Wyncarczyk, 1988; Krishnan, Krishnan, & Stephens, 1996). One factor is auditor tenure.

The aim of this paper is to analyze how tenure affects audit quality in foundations. Quality is defined from the viewpoint of external users of the financial statements as the likelihood that an auditor will submit a qualified opinion. A sample of 254 audits carried out between 2003 and 2010 was used, representing 46 different foundations. Several logistic regression models were calculated to measure in different ways the effect of auditor tenure on audit quality.

The results show that, although audit quality diminishes as the period of auditor tenure increases, this loss of quality does not become apparent until the sixth year of the foundation–auditor relationship. In fact it improves over the first five years. The empirical evidence of this relationship is important for public auditing given that it highlights the need for the introduction of tenure-reducing measures which, at the same time, also ensure a minimum tenure period.

The remainder of the paper is organized as follows: The first section reviews relevant literature regarding audit quality and auditor tenure. The second section explains regulations concerning foundation audits and the hypothesis behind the research. The third section outlines the study's methodology. Results follow in the fourth section and, finally, conclusions.

## 2. Prior research

DeAngelo (1981) defines audit quality as the probability of an auditor discovering errors in a client's finances and then bringing

these errors to light in the audit report. Audit quality, therefore, depends on auditor competence and independence.

Competence is associated with an auditor's professional skills and independence may be real (the auditor's unbiased or objective attitude), or just appear to be so (different user perception of independence). Some literature on the subject of audit quality considers that the auditor is able to separate both features, while other authors assume them to be linked. Thus, if an auditor is competent, the more likely they are to be independent (Richard, 2006).

Given that it is difficult to come up with a proxy which can assess both auditor competence and independence at the same time (Vanstraelen, 2000, 420), and that the cost of measuring the quality of the auditor's work is highly significant, consumers develop subrogates for audit quality (proxies) which may be correlated to quality (DeAngelo, 1981). Carcello, Hermanson, and Huss (1995) point out some of these which have been used by other authors: litigation against law firms, auditor selection, auditor changes and firm size, nature of auditors' opinions, pricing of audit services and user perception.

Also, over the last few decades researchers have analyzed determining factors in audit quality as well as the effect of auditor tenure on quality, with a number of studies devoted principally to the latter and undertaken in the private sector – Table 1 summarizes some of the works published in this regard.

Specialized literature on the subject has pointed out the lack of consensus concerning the audit quality–auditor tenure relation (Vanstraelen, 2000) because auditor tenure can have a positive or negative impact on the two main determinants of audit quality: auditor competence and auditor independence.

Geiger and Raghunandan (2002), Myers, Myers, and Omer (2003), Ghosh and Moon (2005), Knechel and Vanstraelen (2007) and Jackson, Moldrich, and Roebuck (2008) have shown that audit quality improves with auditor tenure. However, Levinthal and Fichman (1988) and Deis and Giroux (1992) show just the opposite. By measuring tenure as the number of years an auditor has audited a company, these studies consider the audit quality–auditor tenure relation to be linear.

Ruiz, Gómez, and Carrera (2006) suggest that divergences from an empirical point of view may be due to the fact that audit quality does not vary in a linear way over the duration of the contract and that it may change depending on the duration of client/auditor relationship.

Long auditor tenure may increase competence because the auditor's client-specific knowledge increases over the years (St. Pierre and Anderson, 1984). This will allow them to improve the quality of their auditing but it could also reduce their degree of independence in the sense that a long auditor–client relationship may make the auditor financially reliant on the client (Ruiz et al., 2006) and bring about such a close relationship (Whittington, Grout, & Jewitt, 1995) that unbiased assessment is compromised (Shockley, 1981) by lack of both innovation and procedural rigour (Shockley, 1982).

Johnson, Khurana, and Reynolds (2002) claim that specific client knowledge gained over the years could entail a reduction in auditor effort, yet this does not necessarily involve a threat to the quality of the work.

Short auditor tenure could negatively affect competence because auditors' client knowledge is less over the first few years and they need time to get used to their clients' activity and accounting procedures (Carcello & Nagy, 2004). Their independence could also be compromised since they need to keep new clients in order to recover their initial client-specific investment, which cannot be transferred to other contracts (Ruiz et al., 2006).

Industry specialization, however, can improve both competence and independence, leading to higher audit quality since auditors know their sector far better than non-specialist firms and can audit

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