

Does Auditor Tenure Reduce Audit Quality?

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Abstract: Reduced auditor independence and the rise of corporate accounting manipulations have caused trust of the users in audited financial statements to begin to decline, so users of financial statements are questioning whether public accountants are independent parties. This research issue is related to the Decree of the Minister of Finance No. 17 in 2008 about public accountant services. Giving attestation services, in the form of financial statements about an entity, are conducted by the audit firm for no longer than 6 consecutive fiscal years and by a public accountant for 3 consecutive fiscal years at the longest. The purpose of this research is to examine empirically the influence of auditor tenure on audit quality. Auditor tenure is measured as the length of the auditor-client relationship. Audit quality is measured by the propensity of auditors to issue a going-concern opinion. This study uses a sample of firms listed on the Indonesia Stock Exchange during the 2003-2008 period. Research analysis uses logit model to measure the effect of auditor tenure on the auditors' propensity to publish a going-concern opinion. The hypothesis which states that the length of auditor tenure influences negatively the propensity of auditors to issue a going-concern opinion is statistically supported. This research is expected to provide empirical evidence about the importance of limiting of the auditor-client relationship.

Abstrak: Berkurangnya independensi auditor dan maraknya manipulasi akuntansi korporat membuat kepercayaan para pemakai laporan keuangan auditasi mulai menurun, sehingga para pemakai laporan keuangan mempertanyakan eksistensi akuntan publik sebagai pihak independen. Isu penelitian ini berkaitan dengan peraturan Menteri Keuangan No. 17 tahun 2008 tentang jasa akuntan publik. Pemberian jasa attestasi atas laporan keuangan dari suatu entitas yang dilakukan oleh Kantor Akuntan Publik paling lama untuk 6 (enam) tahun buku berturut-turut dan oleh seorang Akuntan Publik paling lama untuk 3 (tiga) tahun buku berturut-turut. Tujuan penelitian ini adalah untuk menguji secara empiris pengaruh tenur auditor terhadap kualitas audit. Tenur auditor diukur dengan lamanya hubungan auditor dengan klien. Kualitas audit diukur dengan kecenderungan auditor mengeluarkan opini *going concern*. Penelitian ini menggunakan sampel perusahaan yang terdaftar di Bursa Efek Indonesia periode 2003-2008. Analisis penelitian

menggunakan model logit untuk mengukur pengaruh tenur auditor pada kecenderungan auditor mengeluarkan opini *going concern*. Hipotesis yang menyatakan bahwa terdapat pengaruh negatif tenur auditor pada kecenderungan auditor mengeluarkan opini *going concern* secara statistik didukung. Penelitian ini diharapkan dapat memberikan bukti empiris tentang pentingnya pembatasan hubungan auditor dengan klien.

Keywords: audit quality; auditor tenure; going concern; reputation

Introduction

This paper aims to test empirically whether auditor tenure can reduce audit quality. This research issue relates to the Decree of the Minister of Finance No. 17 of 2008 on public accountant services. Attestation services producing financial statements for an entity are conducted by the audit firm for a maximum of 6 consecutive fiscal years and by a public accountant for a maximum of three consecutive fiscal years. The auditor tenure is measured by the length of the relationship between the auditor and the client (Mansi 2004). One of the audit quality indicators is the tendency of auditors to issue a going concern opinion (Geiger and Raghunandan 2000; Carey and Simnett 2006; Knechel and Vanstraelen 2007). They assume that the decline in audit quality is indicated by the auditor not issuing a going-concern opinion for firms experiencing financial difficulties.

The Indonesian Institute of Accountants has adopted the auditing standards that relate to the going-concern assumption established in the United States in SAS no. 59. In 1988 the Auditing Standards Board (ASB) issued Statement on Auditing Standard (SAS) No. 59: *"The auditor's consideration of an entity's ability to continue as a going-concern which asks the auditor to evaluate whether there is substantial doubt about the ability of the company client to continue as a going-concern or not."* The Indonesian Institute of Accountants adopted SAS No. 59 to Statement of Auditing Standards No. 30 regarding the consideration of entities ability to survive in the auditor's opinion. Statement of Auditing Standards No. 30 requires the auditor's report to give warning to the users of financial statements. There is skepticism about the ability of the company, as an entity, to survive for at least one accounting

period after the date of the financial statements or, collectively, the appropriate time period.

Reduced auditor independence and the rise of corporate accounting manipulations have begun to cause the trust of users of audited financial statements to decline, and they may question whether public accountants are independent parties. The Enron case demonstrated the desire of directors to obtain incentives such as bonuses encouraged them to manipulate the financial statements that resulted in bankruptcy of the company. The fraud committed by Enron involved the international accounting firm Arthur Anderson (AA) too. Arthur Anderson is one of the Big Five public audit firms. It intentionally or unintentionally had been trying to cover the financial problems faced by Enron. It caused huge losses for investors in the U.S. and around the world.

The results of studies that examine the effect of tenure and partner tenure on audit quality show inconclusive results. The results indicate a rejection of the statement about the negative effect of auditor tenure and partner tenure on audit quality (Ghosh and Moon 2005; Myers et al. 2003; Geiger and Raghunandan 2002; Manry et al. 2003). Other research findings indicate that audit quality decreases with the increasing duration of the auditor tenure (Davis et al. 2002 in Ghosh and Moon 2005). Knechel and Vanstraelen (2007) showed that the decision of auditor to issue a going-concern opinion was not influenced by the auditor tenure in a sample of bankrupt companies. In this sample, they found some evidence of a negative relationship between tenure and auditor's going-concern opinion. They further state that the evidence of whether auditor tenure either improves or degrades the quality is weak. Carey and Simnett (2006) showed that

there were significant negative relationships between partner tenure and audit quality.

The inclusion of the explanation about the company's condition in the notes of financial statements and audit opinions is considered largely in public accountancy as a 'warning' to the readers of financial statements about the company's financial condition (Purba 2009: 78). When the economic climate is one of uncertainty, investors expect auditors to provide an 'early warning' for the possibility of a company's financial failure (Praptitorini and Januarti 2005). The investors will rely heavily on information issued by the auditor for making investment decisions. Users of financial statements should be alert for the possible failure of a company, due to operational and financial problems, as well as external companies.

However, in most management companies, the inclusion of an explanation about the company's condition, either in the notes of financial statements or as an auditor's opinion, is feared because it can create a bad image for the company. The public accountant could worsen the situation by causing pessimism on the part of financial statement readers. The company could actually go bankrupt because of the creation of such a bad image by the external auditors. It could become a 'self-fulfilling prophecy' created by the the auditors.

Furthermore there are numerous studies that reveal the factors associated with going-concern opinions, they are Mutchler (1984; 1986); Menon and Schwartz (1987); Dopuch et al. (1987); Koh (1991); Koh and Tan (1999); Geiger and Raghunandan (2002); Ghosh and Moon (2004); Geiger and Rama (2006); Kirkos et al. (2007) and Haron et al. (2009). Research in Indonesia related to going-concern opinions has been performed by

Fanny and Saputra (2000); Mayangsari (2003); Komalasari (2004); Santosa and Wedari (2007); Januarti and Fitriani (2008). These studies use different variables that are both financial and non-financial.

Audit quality is measured by the propensity of the auditor to issue a going-concern opinion. The results of this study indicate that the decision by an auditor to issue one is influenced by the auditor's tenure. The results of this study are expected to contribute to and support the regulation of the quality of auditing by the regulator with regard to auditor rotation. The composition of the study: in the next section we provide a review of theory and literature about auditor tenure and audit quality; the third section discusses the research method; the fourth section discusses the analysis; and the last section presents conclusions and suggestions.

Theory and Hypothesis

Regulation of Going-Concern

Bellovary et al. (1976) explain that before 1962 there had been no formal guidance on the assessment of the going-concern status of a company in America. Then in 1962, the Stock Exchange Commission (SEC) was the first to address issues of going-concern when it issued Accounting Series Release (ASR) No. 90. In 1974, the AICPA issued SAS No. 2, which provided the first specific discussion about items that are important to consider when assessing the company's going-concern status. After issuing SAS No. 34 in 1981, the AICPA then issued SAS No. 59 in 1988, that further discussed this topic. There were three main changes from SAS No. 34 to SAS No. 59, namely stipulating the following requirements that: (1) the auditor will

consider the going-concern status of clients for each audit engagement, (2) the audit report will be modified if there is substantial doubt about the going-concern status of companies, and (3) audit report will include an explanatory paragraph regarding any substantial doubt.

In 1988 the Auditing Standards Board (ASB) issued Statement on Auditing Standard (SAS) No. 59: 'The auditor's consideration of an entity's ability to continue as a going-concern' that asks the auditor to evaluate any substantial doubt about the ability of the client company to continue as a going-concern. SAS No. 59 asks the auditor to accumulate and evaluate evidence to determine whether the going-concern status is questionable or not. The auditors consider the issuance of a going-concern opinion if they find a reason for doubting the sustainability of an enterprise based on testing.

The Indonesian Institute of Accountants adopted a 59 about the auditor's consideration of the entities' ability to continue to survive. 59 required the auditor to give warning to the users of financial statements. This is where there is skepticism about the ability of company, as an entity, to survive for at least in one accounting period after the date of the financial statements, or collectively, the appropriate time period. 59, paragraph 2, states that the auditor is responsible for evaluating any major doubts about the continued survival of entities the within a reasonable period of time, not more than one year from the date of the financial statements being audited (the next period will be referred to the appropriate period). Evaluation of the auditor is based on knowledge of existing conditions and events that have occurred during or before completing field work. Information about conditions and events is

obtained from the application of audit procedures. They are planned and implemented to achieve the objectives of the audit. It is concerned with the assertions of management contained in the financial statements being audited, as described in section Auditing Standards 326.

Statement of Auditing Standards No.30 requires the auditor to give warning to the users of financial statements, that there is a doubt about the ability of the company as an entity, to survive, at least in one accounting period after the date of this report or referred to the appropriate period. Statement of Auditing Standards 30 paragraph 2 requires that the auditor is responsible for evaluating any major doubts on the entities ability in the continued survival within a reasonable period, not exceeding one year from the date of the financial statements being audited.

Tenure and Audit Quality

Decree of Ministry of Finance No. 17 of 2008, the second part, describes the restrictions on the provision of auditor services. In this case the provision of general audit services about the financial statements of an entity is referred to in paragraph (1) letter a. It is carried out by an audit firm for 6 consecutive fiscal years at most and by a public accountant for a maximum of three consecutive fiscal years. Auditor tenure shows long auditor-client relationships (Mansi 2004). Auditor tenure can have a negative impact on auditor independence. Long auditor tenure can improve the competence of auditors as they can base their decisions on the extensive knowledge that they have developed over time, or it can damage the independence of the auditors because the long-standing relationship fosters closeness between management and auditors. Short auditor tenure can

undermine the competence of auditor because the auditor may have a lack of knowledge about the company in the early years of auditing. It also could damage the independence of auditors, as auditors will want to retain new clients long enough to cover the cost of setting the initial audit or lowball fee (Dye 1991).

There are two main arguments supporting a negative association between the duration of auditors tenure and audit quality: (1) the threat to the independence that may result from growing personal relationship between the auditor and the client, and (2) reduction in audit partner capacity to give a critical appraisal (Carey and Simnett 2006). The development of personal relationships between client management and audit partner would threaten auditor independence. Mauts and Sharaf (1961: 231) state that the auditor should be aware of the various pressures that tend to influence their attitudes and thus slowly but surely threaten their independence. The threat to independence is not only happening at the time of reporting, but it also has the potential to impact assessment carried out during the audit (Dopuch et al. 2003; Bazerman et al. 1997). Thus, this suggests that a long personal relationship would impact auditor independence and objectivity. Specific arguments are that the consequences of decreasing independence with the length of partner tenure of an auditor, include the possibility of surrendering to the inevitable pressure of clients in audit conflict situations and, in the extreme, the possibility that the excessive familiarity would result in collusion between client and auditor (McLaren 1958).

Proponents of auditor rotation argue that the rotation will provide a 'fresh look' at the company's financial information (Davis et al. 2000). They claim that the longer an audit firm maintains a client, the less that

audit firm is able to maintain its objectivity when examining a client statement, and the more likely there will be no mistakes that are detected in the financial statements.

Lack of objectivity has a variety of sources. First, it is said that from time to time it is identified when auditors begin to act as advocates for management. As a consequence, rather than see the assertions of management with appropriate professional skepticism, auditors will look at it from the perspective of support for the management. Second, auditors become unsuccessful at seeing and inserting new evidence or a change in the client's situation into their assessment. This behavior may lead to the auditor's failure in revising assessments about the compliance during the previous year, despite the assertions of facts and circumstances that have changed (for example, failure to give proper weight to new evidence regarding the possibility of loss contingencies). Lastly, it is said that the ability to retain clients without any time limit provides an incentive for auditors to defer to the client in the case of a dispute, and if the auditors do otherwise it would result in the loss of the client. This argument is supported by studies showing the startup costs that are incurred by the auditor during the first year of involvement, and that the auditor can obtain economic rents for the next year's audit as long as they retain the client (DeAngelo 1981; Davis et al. 1993; O'Keefe, et al. 1994).

Longer auditor tenure may be associated with reduced alertness through overfamiliarity with the client (Mautz and Sharaf 1961). The long duration of auditor tenure may create economic incentives for auditors to be less independent. In this case, the auditor can accept clients' demands in order to continue to secure audit fees in the future (Hoyle 1978). Davis et al. (2002) con-

clude that audit quality decreases as the length of tenure increases (Ghosh and Moon 2005). Knechel and Vanstraelen (2007) show that the auditor's decision to issue a going-concern opinion is not influenced by tenure. In their sample of bankrupt companies, they did not find any evidence of a negative relationship between auditor tenure and publishing a going-concern opinion. They further state that the evidence of tenure either improving or degrading the quality is weak. Carey and Simnett (2006) show there are significant negative relationships between audit partner tenure and the quality of audits. Based on theories and research that have been explained above, the hypothesis can be formulated as follows:

Hypothesis: auditor tenure negatively influences the propensity of auditors to issue a going-concern opinion.

Research Methods

Data

This study uses data from companies listed on the Indonesia Stock Exchange between 2003 and 2008, that consistently present information on the financial statements and the reports of independent auditors.

Research Model

$$GC = a + b_1 \text{Tenure} + b_2 \text{Reputation} + b_3 \text{Size} + e$$

Operational Definition

Dependent Variable

Dependent variable is a dummy variable related to the opinion given by the auditor. An auditor who concludes that there is substantial doubt regarding the suitability of the assumption of going-concern will give going-concern opinion. While the clean opinion is the auditor's opinion given to the company's financial statements presented fairly in accordance with generally acceptable accounting standards. Clean opinion is also called an unqualified opinion. Dependent variable gives the value 1 if the auditor's going-concern opinion is given.

Independent Variable

The independent variable used in this study is tenure. To measure this variable, the researchers used data about how long the audit firm has had a relationship with the clients, measured in years. Based on the Decree of Minister of Finance No: 17/PMK.01/2008 of public accountant services, and the Chairman of Bapepam Regulation No. Kep-310/BL/2008 of service governing public accountant regard that the provision of general audit services of the financial statements of an entity by an audit firm should last for a maximum of six consecutive fiscal years while by a certified public accountant it is a maximum of three consecutive fiscal years.

Control Variable

This study used two control variables, namely the auditor's reputation and company size. Auditor reputation is measured by us-

ing a categorical variable. Researchers provide a value of 1 if the audit firm is included in the Big 4. And they profit value of 0 if it is not included in the non Big 4. Mutchler, Hopwood, and McKeown (1997) found evidence of univariate where Big 6 auditors tend to issue going-concern audit opinions on the companies that experience financial distress more than non-Big 6 auditor. Large audit firms can provide better quality audits than small firms, including the express going-concern problem. DeFond, Raghunandan, and Subramanyam (2002) show evidence that the Big 4 audit firms are more likely to report going-concern audit report problems than non-Big 4 firms. Company size is a control variable, as it is measured using the natural log of total assets of the company. Previous research indicates that the auditor issues a going-concern opinion that is inversely proportional to the size of the client company (Mutchler et al., 1997; Knechel and Vanstraelen 2007).

Analysis

Data Description

Based on the criteria of the sample obtained in the following data (Table 1).

Table 2. **The Auditor's Opinion Data**

Opinion	Year						Total
	2003	2004	2005	2006	2007	2008	
Going concern	72	70	61	46	49	49	347
Clean opinion	17	19	28	43	40	40	187
Total	89	89	89	89	89	89	534

Based on the opinion issued by the auditors on 89 samples of the company see are Table 2.

Descriptive Statistics

Based on the descriptive analysis (Table 3), it shows that tenure range is from 1 to 11 years, and the average is 3.1667. This indicates that the samples obtained from the engagement between the auditor and the client. There is a commitment that goes beyond the limits set by the government. The period of the engagement between the auditors and client are on average more than 50 percent of the allowable period of engagement

Table 1. **Sample Data**

Description	Total
Companies that publish financial statements from the year 2003 - 2008 consistently	126
Data incomplete	(37)
Sample	89

Table 3. Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
OPINION	534	.00	1.00	.6517	.47688
TENURE	534	1.00	11.00	3.1667	1.98785
REPUTATION	534	.00	1.00	.4869	.50030
ASSET	534	8.00	15.00	11.6180	1.05395
Valid N (listwise)	534				

Test Feasibility of Regression Models

Based on the omnibus test of model coefficients, it indicates any significant models. The model presented is expected to explain variations in the independent variable and the dependent variable. Nagelkerke R Square value indicates the value of 0.037, which means that the variation of the independent variables could explain the 3.7 percent of the dependent variable, while the rest is influenced by other variables that's not included in the research model (Table 4). Although the value of Nagelkerke R Square is relatively small, there does not mean a model misspecification. The standard error values of the constants are quite large, which means that many possible variables have not been included in the model. This is certainly an opportunity for subsequent research. The level of model predictions are 98 percent for going-concern, and 7 percent for the clean

opinion. Overall the variables tenure, reputation, and firm size can explain the going concern opinion by 66.3 percent (Table 5).

Testing of Hypothesis

The results of the analysis of auditor tenure influence the issuing opinions of going propensity can be seen in Table 6.

According to the analysis of tenure variable, the value of the coefficient of -0.124 with a significance level of 0.009 is indicated. The negative coefficient suggests that the longer the auditor's tenure, the lower the tendency for the auditors to issue a going-concern opinion. Further figures show a significance value less than 0.009 alpha 0.05. Therefore, it statistically supports hypothesis presented. The results support previous research findings conducted by Davis et al. (2002), Carey and Simnett (2006) and Knechel and Vanstraelen (2007).

Table 4. Omnibus Test of Model Coefficient

Model Summary			
Step	-2 Log likelihood	Cox and Snell R Square	Nagelkerke R Square
1	675.997 ^a	.027	.037

a. Estimation terminated at iteration number 4 because parameter estimates changed by less than 0.001.

Table 5. The ability of the model in explaining the going-concern opinion Classification Table^a

Classification Table ^a					
Observed		Predicted			
		OPINION		Percentage Correct	
		Clean	gc		
Step 1	OPINION	clean	13	173	7.0
		gc	7	341	98.0
Overall Percentage				66.3	

a. The cut value is 0.500

Table 6. Statistical Testing

Variables in the Equation							
		B	S.E.	Wald	df	Sig.	Exp(B)
Step 1 ^a	TENURE	-0.124	0.048	6.803	1	0.009	0.883
	REPUTATION	0.537	0.213	6.362	1	0.012	1.710
	ASSET	0.078	0.099	0.611	1	0.434	1.081
	Constant	-0.127	1.114	0.013	1	0.909	0.881

a. Variable(s) entered on step 1: TENURE, REPUTATION, ASSET.

Therefore it is a conflict of interest that can not be avoided. The auditor will lose its independence and accommodate clients' interests, with the hope of the engagement with the clients will not be disconnected. If the assignment of auditors are now preserved for a long time in the future, then most likely, the auditor will feel comfortable. Therefore the objectivity of the audit will be undermined (Mautz and Sharaf 1961). Auditor reputation variables as control variables show a significant value. These findings support the research of Lennox (1999), Geiger and Rama (2006). While the size variable does not significantly affect the issuance of going-concern opinions. These findings support the research of Chen et al. (2001), but are in contrast to the results of research are Wedari and Santosa (2007).

ship with the client is still being debated. Setting the auditor's relationship with clients is important because relationships with auditors arranged by the management can reduce the independence of auditors. This study examines empirically the impact of auditor tenure on audit quality. According to the statistical analysis, the length of relationship between auditors and clients has a significantly negative effect on the propensity to issue going-concern opinions. Therefore the hypothesis that was previously stated is supported by the statistics. The research still has limitations in terms of both of the variables tested and the study sample. Subsequent research can be expanded by looking at other indicators of audit quality, auditor rotation properties and expanding the sample data. Further research can also be extended to examine several variables that may affect auditor tenure.

Conclusion and Suggestion

According to the results of the research, setting limitations on the auditor's relation-

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