

Does Partner's Tenure Matter to Auditor's Independence?

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Abstract

Owing to the rising cases of corporate failure and the current debate on auditor independence, this paper sought to examine the effect of partner tenure on auditor independence, as measured by the going concern opinion. A sample of 120 Kenyan firms and data for the years 2011-2018 was used. Data was analyzed through descriptive and inferential statistics, while the hypothesis was tested through logistic estimation model. The findings indicate that partner's tenure has a significant and positive effect on auditors' independence suggesting that auditor's independence is maximized when partners' tenures are shorter. Therefore, the study recommends that firms should not engage auditors for a long tenure; however, the tenure should be sufficient to give auditors an opportunity to understand their clients' business.

Keywords: Audit partner tenure, auditor independence, going concern opinion, unlisted firms.

INTRODUCTION

The importance of auditor independence is well documented and well understood (Irmawan, Hudaib, & Haniffa, 2013; Dogui, Boiral, & HerasSaizarbitoria, 2014) and the issue of how to improve auditor independence is of central concern to academia, the accounting profession, regulators, and the general public. Specifically, many of the major corporate collapsed, for instance Enron and WorldCom, have been attributed to poor audit quality due to lack of auditor independence. Poor audit quality arises in situation where auditors fail to either discover or report material errors/misstatements in the financial reports. Hence, there is an increasing call for shorter partners' tenure, through rotation, across various jurisdictions to sanction unethical audit behaviors. Proponents of auditor rotation suggest that rotating auditors can reduce the possibility of an auditor not being independent; which impairs the quality of financial reporting emanating from long auditor-client relationships (Gavious, 2007). Additionally, in pursuit of retaining a client, a lengthy relationship may make the auditor complacent, less in-depth audit procedures and a learned confidence, which ultimately lead to poor audits. Similarly, an extended relationship with a client is likely to force an auditor to concur with client preferences resulting in poor earnings quality (Siregar, Amarullah, Wibowo, & Anggraita, 2012). Through auditors' partners' rotation, financial statements get a "fresh look", which increases the probability of an auditor detecting material misstatements and/or challenge questionable accounting practices; thus improving audit engagements (Lu, & Sivaramakrishnan, 2009). Therefore, shortening the partner's tenure is considered as an effective strategy of guaranteeing auditors' independence, in addition to averting "opinion shopping" (Chen, Peng, Xue, Yang, & Ye, 2016; Lu & Sivaramakrishnan, 2009). Finally, it has also been argued that rotation of audit partners can stimulate an audit innovation that enables auditors to audit new clients more professionally (Vanstraelen, 2000). Opponents of auditor rotation contend that rotation of auditor

escalates audit startup costs and increases audit failure risk (Bell, Causholli, & Knechel, 2015). They further suggest new auditors rely more on management assertions and representation in the preliminary years of an audit assignments, which increase the likelihood of producing poor audit reports (Myers, Myers, & Omer, 2003). Therefore, as auditors' tenure increases, the auditor gets to know more about the client's business which reduces the auditors' dependence on management estimation; hence improving the audit quality (Lee, Mande, & Son, 2009). Based on the aforementioned, a long auditor- client relationship basically improves audit quality as new auditors lack client-specific knowledge compared to the former auditor (Chen, Lin, & Lin, 2008). In the same line of argument, Lu & Sivaramakrishnan (2009), contend that lack of client's knowledge by a new auditor hinders the effectiveness of the audit process which results in a dead weight loss to society. Also, management resists mandatory auditor rotation, since they face a possible disruptive, time-wasting, and expensive process of recruiting a new auditor (Ionescu, 2016). Moreover, hiring a new auditor also involves rigorous process of familiarizing them with the organization's operations, procedures, systems, industry and the business environment (Kalanjati, Nasution, Jonnergård, & Sutedjo, 2019). Based on the aforementioned conflicting arguments between long and short audit partner-client relationship, the possible loss of auditor independence associated with long audit tenures and the improved audit quality linked to improved audit quality should be balanced. Although, auditor rotation can take place both at the firm or partner level, it is audit partner rotation which has been adopted in certain jurisdictions. Owing to the intensifying debate surrounding audit partner and firm rotation, mandatory audit firm rotation has been introduced in countries such as Italy South Korea, Singapore, and India; while partner rotation is required in the U.S., UK, Netherlands and Germany (Siregaret *al.*, 2012). Despite the fact that the impact of audit firm tenure on auditor independence has been widely investigated, evidence on partner tenure is relatively scarce and limited to just a few countries. Again the findings on the previous research on firm and partner tenure are inconsistent (Garcia-Blandon & Argiles-Bosch, 2017; Chi and Huang 2005, Chi, Huang, Liao, & Xie, 2009). In this paper, we examine the impact of partner's tenure on auditor independence. Although partner's tenure is key in understanding the likelihood of an auditor being independent since rotation minimizes the "familiarity threat, just a few empirical studies have examined this issue (e.g. Manry, Mok, & Turner, 2008; Ryken, Radich, & Fargher, 2007). Prior studies have generally used surveys or conducted experiments with practicing auditors to examine the perceived risk of sanctions on auditors' ethical behavior (Shockley 1982; Farmer et al. 1987; Trompeter 1994; Shafer et al. 1999).

Previous Studies and Hypothesis Development

In the recent past auditors have been criticized for their failure to detect and report financial statement frauds that have contribute to corporate failure and massive financial losses to investors, which has triggered a serious debate on their independence and the need for audit partner rotation. Bakar, Rahman and Rashid (2005) defines auditor independence as "taking an unbiased viewpoint in the performance of an audit test, the evaluation of the results, and the issuance of an audit report".

As discussed in the previous section, there are contradictory opinions on the impact of audit partner tenure on auditor independence as measured by audit quality or going concern opinion. Proponents of auditor expertise and learning argument suggest that audit quality will be lower during the initial years of the auditor-client engagement then improves over time as the information asymmetry between the

auditor and the client reduces. On the contrary, the proponents of auditor independence claim that auditor's independence might be impaired or compromised as the auditor's tenure increases. A probable explanation for this phenomenon is that auditors are more likely to concur with the client's accounting and reporting preferences; implying that the quality of financial reports decrease as auditor tenure increases. Several empirical studies have examined the link between both audit firm and partner tenure and the various measures of auditor independence (audit quality, going concern opinion and discretionary accruals). Some of the research studies suggest those auditors' independence increases as audit partner tenure increases; while other claim that auditors' independence decreases with tenure. Specifically, a stream of studies finds a significant positive association between audit partner tenure and auditor independence. Chi and Huang's (2005) study show that audit partner tenure is negatively and significantly associated with discretionary accruals in the early years of engagement; however, the relationship turns positive afterwards, that is if the tenure exceeds 5 years. They attribute this results to lower earnings quality as the auditor becomes "excessively familiar" with the client. The authors' further claim that audit-firm tenure, rather than partner's tenure, plays a key role in the transition of learning experience. Also, Brody and Moscovice (1998) claims that rotating auditors improves auditors' independence by lowering the influence of a client on audit assignments. The inadequacy influence emanates from the threat of losing clients if the auditors fails to agree with the managements financial reporting preferences. A study by Carey and Simnett (2006) in Australia also indicates that a lengthy auditor-client relationship lowers auditors' likelihood to issue a going-concern opinion to a distressed client. Using evidence from Finland, a sample of 34 listed firms and data for 2007 to 2008, Nasution and Östermark (2013) studied the relationship between auditor fee dependence, auditor tenure, and auditor independence. Auditor independence was measured by discretionary accruals. The findings of their study indicate that short auditor-client relationship is significantly and positively related with absolute discretionary accruals; nevertheless, the findings are statistically significant only in one year audit tenure. Additionally, the results indicate that an extended auditor tenure (estimated to be greater than 3 years) is negatively related with discretionary accruals though this is not statistically significant. Further, the authors concluded that there is no empirical evidence to support the argument that long auditor tenure impairs auditors' independence. Lim and Tan (2009) studied the association between auditor tenure and audit quality. The authors used a sample of 40, 881 firm-years that had data on fee information which was extracted from the Audit Analytics database, and financial information in Compustat for the years 2000 to 2005. The results of this study reveal that firms which are audited by specialists (who have a considerably an extended auditor tenure) are characterized by higher audit quality. A study of Myers *et al.*, (2003) investigated the relation between audit firm tenure and two measures of accruals: discretionary accruals and current accruals. The authors used a sample of all firm-years from 1988-2000 inclusive with sufficient data on the 2001 Compustat annual research and industrial file to estimate accruals. Additionally, findings indicate that the amount of discretionary accruals decrease with an increase in audit tenure; implying that the likelihood of management engaging in earnings management is less as audit firm tenure increases. Overall, the study found no empirical proof that a longer audit firm tenure leads to lower earnings quality. Employing a sample of 401 U.S. listed firm that filed for bankruptcy over the period between 2002 and 2008, Read and Yezegel (2016) examined the association between partner tenure and the quality of audit reporting. The findings demonstrate no statistically significant link between auditor tenure and Type II errors (measured by the probability of an insolvent

company not getting a going concern modified audit opinion prior to bankruptcy) for Big 4 audit firms. On the contrary, for non-Big 4 audit firms the authors found a significant relationship that is non linear. Specifically, auditor tenure has a negative effect non-Big 4 firms' audit reporting for bankrupt firms in the earlier years of an audit engagement and has no noticeable impact in the later years. Thus, the study concluded that long auditor tenure is not related with Type II financial reporting errors. Using a sample of Taiwanese listed firms 1990-2001 that yielded 2665 company-years observations, Chen, Lin, & Lin (2008) studied the relationship between audit partner tenure, audit firm tenure, and discretionary accruals. The findings of the study show a significant negative association between partners' tenure and discretionary accruals (a measure of earning quality). Specifically, the negative association arises after 5 to 7 years of auditor-client relationship. Also, the findings indicate that firm tenure is insignificantly associated with discretionary accruals. Though the authors claim that that audit partner tenure impairs audit quality is misplaced, they failed to independently study cases of positive and negative unexpected accruals. Additionally, the authors omitted the first year of the new partner's audit engagement, though the effect of auditor rotation might be expected to occur over that period.

In contrast, a number of studies have reported a significant negative relationship between partner tenure and auditor independence, thus validating the auditor independence hypothesis. Davis, Soo, and Trompeter (2002) examined the relationship between auditors' tenure and earnings management. The authors used a sample of 855 firms for the years between 1981 and 1998. The findings show a positive relation between partner tenure and absolute discretionary accruals. Additionally, the study shows a significant negative relationship between tenure and absolute analyst forecast errors. Hence, the authors concluded that lengthy auditor-client relationship lowers auditors' independence. Carcello and Nagy (2004) examined the effect of audit tenure and fraudulent financial reporting. The authors compared firms mentioned for fraudulent reporting for the period between 1990 and 2001. The study found that fraudulent financial reporting is more likely to happen in the first three (3) years of the auditor client relationship; and thus concluded that long auditor tenure does not lead to fraudulent financial reporting. Using a sample that consisted of 4,711 firm-year observations, Monroe and Hossain (2013) studied the impact of audit partner tenure on audit quality. The findings show a positive and significant relationship between partner tenure and the likelihood of issuing a going-concern opinion for a financially distressed client. The authors concluded that findings suggest that the implementation of mandatory audit partner rotation has improved audit quality. Similarly, Casterella, Knechel and Walker (2002) who use fraudulent financial reporting as a measure for audit quality and found out that fraudulent report occur more when there is a long audit firm tenure. The finding is attributed to excessive familiarity resulting from a long auditor client relationship which decreases audit quality. Yet Johnson *et al.*, (2002) study that examined the effect of partners' tenure on financial-reporting quality found that an average audit tenure 4 to 8 years) and short tenures (2 to 3 years) are related with lower-quality financial reports. On the contrary, the authors find no evidence for reduced financial-reporting quality owing to extended audit tenure (9 or more years). Given the mixed empirical findings; this study hypothesis is as follows:

H1: There is no significant relationship between partner tenure and auditor independence (measured by the likelihood of auditors to issue going-concern opinions).

METHODOLOGY

Data and sample

Cross sectional data gathered from annual reports of unlisted firms in North Rift Region Kenya was used for this study. The data was extracted from annual audited financial reports for 2011-2018. A sample size of 120 firms was selected using the simple random sampling technique from a population of 3,200 audited unlisted firms operating in North Rift Region of Kenya.

Logistic regression model

The study uses logistic regression model since the dependent variable (auditors' independence) is binary measured by whether the firm receives a going concern opinion (GCO) or not. If the firm gets a going concern it is scored as 1 otherwise 0. The independent variable is partner's tenure measured as the natural logarithm of the number of years an auditor has served a given client. We include four control variables in the model to control for the possible effects of certain client firm characteristics on the auditors' probability of issuing a modified audit opinion; client's firm performance, client's firm leverage, client's firm liquidity and client's firm size (Simamora&Hendarjatno, 2019; Li, 2009). Generally, the lower the profitability level the greater the uncertainty about the firm's ability to finance its on-going activities and hence there is a higher possibility that an auditor will issue a modified audit opinion. Client's firm performance is measured by ROA (return on assets), while client's firm leverage is calculated as the ratio of the total long-term liabilities to the client's total assets. Client's firm liquidity is measured as the ratio of the total current assets over total current liabilities (CA/CL). The study hypothesizes that client firm performance (ROA) and client firm liquidity (CA/CL) will be negatively associated with going concern opinion while client firm leverage will be positively correlated with GCO. Client firm leverage has a positive effect on the GCO owing to eternal monitoring from creditors. We therefore control for leveraging using the ratio of client firm equity to total assets. Client firm size is also an important characteristic that needs to be controlled (Carcello *et al.*, 2010). Smaller clients are more likely to receive a going concern opinion than large ones, because the volume of their operations are small and have fewer assets; hence the management is unlikely to exert unnecessary pressure on the auditor to issue a going concern opinion. Therefore, we expect that client firm size is negatively associated with going concern opinion. We control for client firm size using the natural logarithm of the total assets of the client (LNTA). Therefore, to test the hypothesis, the logistic regression is modeled as follows,

$$AI = \alpha + \beta_1 CFS + \beta_2 CFLQ + \beta_3 CFP + \beta_4 CFLEV + \beta_5 APT + \varepsilon$$

where;

AI is auditors independence; CFS, client firm size; CFP, client firm performance; CFLEV, client firm leverage; APT, audit partner tenure; α , constant; β , beta coefficients; ε , error term

RESULTS AND DISCUSSION

Descriptive statistics

Table 4: Descriptive statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
AIN	960	.5010417	.5002595	0	1
CFP	960	.0216522	.0346548	.0000757	.2868545
CFS	960	15.30357	.9973639	12.72867	18.51404
CFLQ	960	.5683556	.3997107	.0261969	2.168
CFLEV	960	.7606483	.3605847	.0174168	2.313249
APT	960	2.453125	1.676648	1	10

Table 1 reports the descriptive statistics for the research variables. It is reported that (mean 50.1% Std. Dev= 0.500, minimum = 0 and maximum = 1) of the sampled firms received a going concern opinion. The mean value of audit partner tenure variable for the selected firms is 2.453125 (Std. Dev= 1.676648, minimum = 1 and maximum = 10), implying that on average the selected firms had a short auditor-client relationship; although some firms engaged audit partners for long tenures of approximately 10 years. The mean value of client firm performance is 0.021652 (Std. Dev= .0346548, minimum = .0000757 and maximum = .2868545), implying a relatively low return on assets; however, the high standard deviation shows a high variability in performance among the sampled firms. Client firm size is 15.30357(Std. Dev= .9973639, minimum = 12.72867 and maximum = 18.51404), client firm liquidity is 0.5683556 (Std. Dev= .3997107, minimum = .0261969 and maximum =2.168). While the mean score for client firm leverage .7606483 (Std. Dev= .3605847, minimum = .0174168 and maximum =2.313249), suggesting prudent use of debt capital.

Table 5: Pairwise correlation matrix

	AIN	CFP	CFS	CFLQ	CFLEV	LNAPT
AIN	1.0000					
CFP	0.0622	1.0000				
CFS	0.2193*	-0.0517	1.0000			
CFLQ	0.0649*	-0.1529*	-0.0232	1.0000		
CFLEV	0.3419*	0.2005*	-0.0028	-0.4268*	1.0000	
APT	-0.6066*	-0.0255	-0.1932*	-0.0698*	-0.3023*	1.0000

*CFP, Client firm performance; CFS, Client firm size; CFLQ, client firm liquidity; CFLEV, client firm leverage; APT, partners' tenure measured by the number of years a partner serves a client; **p<0.05*

Table 2 presents the results for the Pearson's correlation analysis, with 5% significance levels. Generally, the correlation coefficients are low, with the highest value of -0.6066 between audit partner tenure and auditor independence; therefore, we predict auditor independence would be negatively associated to longer auditor-client relationship. Focusing on control variables, the pairwise correlation matrix illustrates that some rather observable effects, as the correlation pattern of client firm size ($r=0.2193$, $p<0.05$), client firm leverage ($r=0.3419$, $p<0.05$), client firm liquidity ($r=0.0649$, $p<0.05$), with going concern opinion (a proxy for auditor's independence) is positive and significant. However, the correlation between client firm performance and the auditor independence is positive but insignificant ($r=0.0622$, $p<0.05$).

Regression analysis

The regression results auditor independence on audit partner tenure and the controls are presented in Table 3. The overall fitness of the logistic model as shown in the LR statistic of 946.17 with Prob> chi2 0.0000, which is less than the conventional p-value of 0.05. The overall explanatory power of the model has a pseudo R-squared of 0.7110, suggesting that about 71.10 % of the variations of the dependent variable (auditor independence) is explained by the predictor variable which is quite high. Furthermore, the beta coefficient and respective p-value analysis shows statistical significance of the explanatory variable and the control variables on the outcome variables. Based on the regression output the model fit in is illustrated below.

$$AI = -7.016 + 5.50 CFP + 0.51 CFS + 1.28 CFLQ + 3.19 CFLEV - 6.36 APT$$

Table 6: Regression analysis

AIN	Coef.	Std. Err.	Z	P>z	VIF	Tolerance
CFP	5.503883	3.660564	1.50	0.133	1.05	0.9514
CFS	0.5114666	.1359096	3.76	0.000	1.05	0.9503
CFLQ	1.282184	.4232053	3.03	0.002	1.31	0.7655
CFLEV	3.186679	.5322843	5.99	0.000	1.46	0.6863
LNAPT	-6.34122	.4878958	-13.00	0.000	1.22	0.8202
Constant	-7.016537	2.275312	-3.08	0.002		
Pseudo R2	0.7110					
Observations	960					
LR chi2(5)	946.17					
Prob> chi2	0.0000					

*CFP, Client firm performance; CFS, Client firm size; CFLQ, client firm liquidity; CFLEV, client firm leverage; LNAPT, natural logarithm partners' tenure(years); **p<0.05*

Consistent with our hypothesis, the coefficient of LNAPT (natural logarithm of the number of year an audit partner has served a given client) is significant at 5 percent significance level. The negative coefficient of LNAPT implies that partners with long tenure are more likely to issue a going concern audit opinion than those with shorter tenure; thus less independent. These findings are supported by previous studies (Davis *et al.*, 2002; Monroe & Hossain, 2013; Casterella *et al.*, 2002). On the contrary, our findings contradict those of Myers *et al.*, (2003) and Nasution and Östermark (2013), who argue that long auditor-client relationship does not impair auditor's independence. For the control variables, the regression results generally concur with our prediction. Higher client performance (ROA), and high client firm leverage (CFLEV) and high liquidity (CFLQ) increases the likelihood of a firm receiving a going concern opinion (higher level of auditor independence). Surprisingly, smaller clients size (LNTA), is negatively associated with going concern opinion; that is a relatively small firm is more likely to receive a going concern compared to a large firm.

CONCLUSION AND RECOMMENDATION

The objective of this paper was to investigate the impact of audit partners' tenure on auditor independence, measured by the likelihood that an auditor issues a going

concern opinion. The study attempts to provide additional empirical evidence using unlisted Kenyan firms. The findings of the study indicate that there is a significant negative relationship between auditor tenure and auditor independence. Several control variables (client firm performance, client firm leverage, and client firm liquidity) were found to be positively related to auditor independence, while client firm size exhibited a negative effect. Thus, the debate about auditor tenure seems to be an endless debate as evidenced by the plethora of conflicting research findings. Despite the novelty of our findings, this study suffers from one limitation; the inability to pinpoint an appropriate time period that defines what would constitute long or short partner tenure. Similarly, some prior studies have used varied time frames ranging from 3 years, 4 years, which may have effects on empirical findings.

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