International Journal of Innovation and Applied Studies
ISSN 2028-9324 Vol. 10 No. 3 Mar. 2015, pp. 990-997
© 2015 Innovative Space of Scientific Research Journals
http://www.ijias.issr-journals.org/

Effect of Compulsory Rotation of Auditing Institutes on Quality of Financial Reporting

Hamid Reza Nazemi, Narges Saemi Poor, and Abdol Jalil Emami Rad

Department of Accounting, Shahrood Branch, Islamic Azad University, Shahrood, Iran

Copyright © 2015 ISSR Journals. This is an open access article distributed under the ***Creative Commons Attribution License***, which permits unrestricted use, distribution, and reproduction in any medium, provided the original work is properly cited.

ABSTRACT: This research has studied effect of compulsory rotation of auditing institutes on quality of financial reporting in the companies listed in Tehran Stock Exchange. Main goal of the research was to answer this question that if there was significant relationship between compulsory rotation of auditing institutes and quality of financial reporting. To study quality of financial reporting, variables of distinction between declared and diagnostic tax, accounting estimations, deviation from laws, accounting mistakes and accounting procedures have been used as dependent variables.
Statistical population including two sample groups with 50 companies as test group and 50 companies as control group was studied for 4 years during 2009-2012. The required data of the research includes difference discovery acceptance ratio before and after compulsory rotation of auditing institutes. Results of our research showed that rotation of auditing institutes had significant relationship with declared and diagnostic tax distinction and accounting mistakes and increased differences discovery acceptance ratio. But such relationship was not found between rotation of auditing institutes and accounting estimates discovery, deviation from laws and accounting procedures.

KEYWORDS: rotation of auditing institutes, yearly adjustment, quality of financial reporting.

1 INTRODUCTION

The presence of transparent and reliable financial information is one of the main factors of evaluation of the present situation and performance of a company in its activities and also making decision about trade of its securities.

The companies which have lower competitive power try to show them more successful than they are by altering financial information. When growth of company becomes slow or takes undesirable trend, manager tries to show the situation proper by exaggerating sale and other growth criteria [1]

In this regard, reliable and high quality information is the information which has been prepared under supervision of a professional and independent group. The evident example of independent professional groups is auditing institute which studies and supervises on structure of internal control of the reporting unit and its end product i.e. financial statements and makes comment on this case. The previous studies show that auditing report and quality of financial statements are important sign of soundness and performance of company. For this reason, institutional investors try to use high quality auditing services [2]

2 RESEARCH OBJECTIVES

In this research, attempt has been made to study effect of applying quality of auditing as one of the practical strategies for solving problem of auditor's independence and more reliability of auditing report and financial reports of the companies listed in Tehran Stock Exchange. Therefore, performance of this research is important because policies affecting financial reporting has bene explained by the internal and external factors and will cause the investors and stockholders to evaluate capital market more accurately and make more accurate investment decisions. In this research, we study effect of compulsory rotation of auditing institutes on quality of financial reporting.

3 THEORETICAL FUNDAMENTALS

World financial crisis and the destructive outcomes which it has left on international economy led the auditors to perform new duties. Since the first decade of the new millennium and following Enron scandal and dissolution of very large auditing institute of Arthur Anderson to great financial crisis 2008 and financial scandals following it, new conditions were created in activity environment of auditors and the auditors are generally expected to perform some duties. On the other hand, disagreement between auditors and employers has increased with increasing number and complexity of financial and auditing reporting laws. In this regard, we face three issues of change in procedure, change in estimation and correction of mistake in financial reporting. Accounting mistakes may be automatically corrected at the same period and at most in the next period. these mistakes can be discovered because they are transient and short-term but some of the mistakes which affect balance sheet or loss and profit may have long-term effect and lead to presentation or correction of the previous figures in some syllabi due to their effect or importance (in terms of price)(Technical Committee of Auditing Organization). In Iran, almost all yearly adjustments relate to correction of mistakes. Therefore, the presence of yearly adjustments with simple language means that there has been important mistake in financial statements of the past years and if shareholders look at financial statements more carefully, the yearly adjustments contain a negative message about validity of the financial statements [3] ,[4].

3.1 AUDITING QUALITY

It is evident that real independence of auditor and quality of auditing institutes' work which are regarded as key factors for preparation of auditing reports have attracted their attention considering position and role of auditing institutes in decision of users [5]. A common definition of auditing quality has been given by De Angelo. He has defined auditing quality as evaluation of market based on the fact that the auditor:

1- Discovers important alterations in financial statements or accounting system of the employer.
2- Reports the discovered important alteration.

The probability that auditor discovers the impotent alterations depends on competency of auditor and the probability that the auditor reports the discovered important alterations depends on independence of auditor [6].

There are no comprehensive definitions of quality and quantity of auditing which includes all types of auditing and accounting, therefore, some criteria such as size of auditing institutes, nominal age of institutes' merchants, dependency and independency of auditing, auditing committee and auditing committee have been considered as auditing quality indices. In this research, component of compulsory rotation of auditing institutes has been considered as auditing quality index.

Users of the financial statements use information inserted in auditing reports as measurement criterion in management performance of the economic enterprise and also a criterion for determining share price of companies. Therefore, validity and reliability of this information as evidence of quality of validity and reliability of financial statements is very important for the present and future investors, creditors and other users of financial statements. In other words, independent auditors play effective role in promotion of financial reporting quality by adjusting aggressive earning management methods [7] . In addition, they have special position in corporate governance structure in developing markets and they play sensitive role in promotion of financial reporting quality [8].

3.2 COMPULSORY ROTATION OF AUDITOR

In Iran, there was no formulated and formal rotation process of auditing institutes in the past years due to limitation of auditing activity by some large institutes such as auditing institute of National industries Organization and Program and Budget Organization, auditing institute of Foundation of the Oppressed and Disabled and Shahed auditing institute based on legal provisions and only some auditing groups responsible for performance of some special works were rotated at discretion of the managers of the institute. After merging the above institutes and establishing Auditing Organization, the auditing groups responsible for performing work in time periods with mean of 3 years are rotated due to variety of the employers and their high number and for more control and study. This displacement may abdicate accounting responsibility of a company from a manager and delegate it to another manager inside auditing organization. Rotation process is done only among different groups inside auditing organization and is not included in auditing institutes rotation law concurrently and synonymously with other countries. Tehran Stock Exchange Organization enacted manual of trustworthy auditing institutes of Stock Exchange Organization which required regular rotation of auditing institutes in four-year periods on 30 July 2007 [9].

4 HISTORY

Nashwa (2004) tried to prove that long-term relation can increase probability of auditing failures. Failure of 90 American companies was divided into three parts of judicial claims, bankruptcy and sanction by Stock Exchange Commission between 1996 and 2001. Results of his/her study show that most failures occur during the early auditing years. In recent years, risk of relationship between auditor and employer has increased. At the end, the researcher concludes that results of his studies doesn't confirm this hypothesis that rotation of the auditing institutes improves auditing quality.

Michael Atraj et al. (2010) concluded that the companies which have fraud-free restatement provided lower balance sheet volume than the companies which had restatement of financial statements resulting from deception and mistake.

Hirkery et al.(2013) in their research studied relationship between restatement of figures in financial statements and quality of financial reporting in 381 American companies between 2001 and 2007. Results of their research showed that quality of financial reporting has decreased with increasing the restated figures in financial statements.

According to Dan li (2010), auditors have loyalty feeling in long auditing and this questions competency of auditors for a high quality and effective auditing. He also conducted a research on relationship between auditor-employer and conservative reporting and concluded that this relationship is positive in large companies and the companies which are controlled and monitored by the auditor but this relationship is negative for the companies which are not monitored by auditors.

Mojtahed Zadeh and Aghaei(2004) in a research studied factors affecting independent auditing quality from the viewpoint of independent auditors and users. The statistical population included users of auditing services including managers, investment companies and managers of credit section of banks and independent auditing group. Results showed that there was no significant difference between attitudes in most cases.

5 RESEARCH HYPOTHESES

Main objective of the present research is to study effect of rotation of auditing institutes on financial reporting quality. To reach this objective, 5 hypotheses have been uses as follows:

Hypothesis 1: There is significant relationship between compulsory rotation of auditing institutes and declared and diagnostic tax distinction.
Hypothesis 2: There is significant relationship between compulsory rotation of auditing institutes and auditing estimations.
Hypothesis 3: There is significant relationship between compulsory rotation of auditing institutes and deviation from laws.
Hypothesis 4: There is significant relationship between compulsory rotation of auditing institutes and accounting mistakes.
Hypothesis 5: There is significant relationship between compulsory rotation of auditing institutes and accounting procedures.

6 RESEARCH METHOD

The research project is quasiexperimental and uses Ex post facto approach. On the other hand, the present research is one of the descriptive-correlative researches. The used method was conducted with paired mean comparison test with SPSS software to study significance of effect of compulsory rotation of the auditing institutes on dependent variables. The statistical population of the research included companies listed in Tehran Stock Exchange. Quality of information and east access to information of financial statements and other information (attached notes) are of the most important reasons for selection of a statistical population which are adjusted considering the following limitations:

1- They should not be included in investment and Financial Intermediation companies, insurances and banks. Investment, financial and intermediation companies because they have different financial statements from other companies are excluded from the selective sample.
2- End of their financial year is 20 March.
3- Their shares have been traded in time period.
4- They should be active in the stock exchange during the studied time period that is they have not been excluded from the stock exchange.
5- Full information of the company and notes along with financial statements are accessible.

In this research, two sample groups (control and test) were used for testing the research hypotheses. The test group includes the companies in which auditing institute has changed during the research period and the control group includes the companies in which auditing institute has been fixed during the research period and has not changed. Attempt has been

made to select companies of the control group similarly to companies of the test group. For this purpose, companies of the control group should be similar to companies of the test group in terms of industry type and financial year. Goal of determining the control group and test group is to neutralize effect of other factors and validate results of the research.

By applying the above hypotheses, 50 companies were selected for the test group and 50 companies were selected for the control group.

7 THE RESEARCH VARIABLES

The independent variable in this research is compulsory rotation of the auditing institutes and dependent variables which have been used for studying quality of financial reporting includes declared and diagnostic tax distinction, accounting estimates, deviation from laws, accounting mistakes and accounting procedures.

8 ANALYZING AND TESTING HYPOTHESES

8.1 DESCRIPTIVE STATISTICS

Table 1: Statistical description of test group data

Standard deviation	Variance	Mean	Success ratio	Time range	Type of deviation
0.4011	0.161	0.5907	33.1	Before chnzge	**Declared and diagnostic tax distinction**
0.2745	0.075	0.8318	46.61	After change	
0.2559	0.066	0.9047	50.66	Before change	**Accounting estimates**
0.1775	0.032	0.9300	52.1	After change	
0.2902	0.084	0.8660	48.51	Before change	**Deviation from laws**
0.2811	0.079	0.8898	49.84	After change	
0.2499	0.062	0.9117	51.06	Before change	**Accounting mistakes**
0.07300	0.005	0.9851	55.16	After change	
0.3191	0.102	0.7797	43.66	Before change	**Accounting procedures**
0.2888	0.083	0.8348	46.75	After change	

Table 2: Statistical description of control group data

Standard deviation	Variance	Mean	Success ratio	Time range	Type of deviation
0.3291	0.108	0.7946	44.51	Before change	**Declared and diagnostic tax distinction**
0.3288	0.108	0.8407	47.1	After change	
0.1483	0.022	0.9732	54.5	Before change	**Accounting estimates**
0.1588	0.025	0.9538	53.43	After change	
0.2024	0.041	0.9449	52.92	Before change	**Deviation from laws**
0.2059	0.042	0.9196	51.51	After change	
0.2523	0.064	0.8683	48.61	Before change	**Accounting mistakes**
0.2238	0.050	0.9171	51.37	After change	
0.2176	0.047	0.9204	51.55	Before change	**Accounting procedures**
0.2294	0.053	0.8903	49.87	After change	

The research hypotheses are statistically mentioned as follows:

H_0: $\mu_d = 0$

H_1: $\mu_d \neq 0$

8.2 INFERENTIAL STATISTICS

Testing the first hypothesis: There is significant relationship between compulsory rotation of auditing institutes and declared and diagnostic tax distinction.

Table 3- Results of testing paired mean comparison of the first hypothesis for the test and control groups

Confidence interval of 95%		Significance level	Degree of freedom	t statistic	Number of companies	Paired variables	Group
Upper limit	Lower limit						
0.3697	0.1123	0.000	55	3.754	50	**Mean success ratio of the declared and diagnostic tax distinction discovery before and after change**	**Test**
0.1322	0.1013-	0.288	55	1.073	50	**Mean success ratio of the declared and diagnostic tax distinction discovery before and after change period**	**Control**

Considering that the obtained significance level is below 0.05 for the test group, hypothesis H_0 regarding equality of mean success ratio of the declared and diagnostic tax distinction of two populations is rejected in confidence level of 95% and it can be concluded that mean success ratios of the declared and diagnostic tax distinction of two populations are not equal and it means that compulsory rotation of auditing institutes of the test group has been effective on success ratio of distinction discovery by the auditing institutes. Considering that the upper limit (0.3697) and lower limit (0.1123) are positive, it can be concluded that mean success ratio after compulsory rotation of auditing institutes is higher than mean success ratios before it, therefore, it can be said that compulsory rotation of auditing institutes increased success ratio of the auditing institutes in the declared and diagnostic tax distinction, therefore, the first hypothesis of the research is accepted.

Considering that the obtained significance level is above 0.05 for the control group, hypothesis H_0 regarding equality of mean success ratios of the declared and diagnostic tax distinction of two populations is not rejected in confidence level of 95% and it can be concluded that there is no significant difference between mean success ratios of the declared and diagnostic tax distinction before and after compulsory rotation of the auditor. Confidence level of 95% for mean differences in a positive and negative intervals also confirms this claim. This result more strongly proves effect of compulsory rotation of auditing institutes on success ratio of declared and diagnostic tax distinction because the control group was selected similarly to the test group in terms of industry type, size and financial year with this difference that the auditing institutes of the control group had no rotation during the study term.

Testing the second hypothesis: There is significant relationship between compulsory rotation of auditing institutes and accounting estimates.

Table 4- Results of testing paired mean comparison of the second hypothesis for the test and control groups

Confidence interval of 95%		Significance level	Degree of freedom	t statistic	Number of companies	Paired variables	Group
Upper limit	Lower limit						
0.1093	-0.0587	0.549	55	0.603	50	**Mean success ratio of the accounting estimates discovery before and after rotation of auditor**	**Test**
0.0403	-0.0790	0.519	55	-0.649	50	**Mean success ratio of the accounting estimates discovery before and after rotation period of auditor**	**Control**

Table 4 shows that the obtained significance level is above 0.05 for the test and control groups, hypothesis H_0 regarding equality of mean success ratios of the accounting estimates discovery in two groups is not rejected. Therefore, it can be concluded that there is no significant difference between success ratios of the accounting estimates discovery before and

after compulsory rotation of the auditing institutes. As expected, there is also significant difference between success ratios of the accounting estimates discovery before and after compulsory rotation period for them. Confidence level of 95% for mean differences between two tests and control groups in a positive and negative interval also confirms this claim. Therefore, it can be said that there is no significant relationship between compulsary rotation of the auditing institutes and the accounting estimates discovery and this change has no significant effect on success ratios of the accounting estimates discovery. Therefore, the second research hypothesis is not accepted.

Testing the third hypothesis: There is no significant relationship between compulsary rotation of auditing institutes and deviation from laws.

Table 5- Results of testing paired mean comparison of the third hypothesis for the test and control groups

Confidence interval of 95%		Significance level	Degree of freedom	t statistic	Number of companies	Paired variables	Group
Upper limit	Lower limit						
0.1191	-0.0715	0.619	55	0.501	50	**Mean success ratio of deviation from laws before and after rotation period**	**Test**
0.0380	-0.0886	0.427	55	-0.8	50	**Mean success ratio of deviation from laws before and after rotation period**	**Control**

Table 5 shows that the obtained significance level is above 0.05 for the test and control groups that is hypothesis H_0 regarding equality of success ratio of deviation from laws in two groups is not rejected. Therefore, it can be concluded that there is no significant difference between success ratios of deviation from laws before and after compulsory rotation of the auditing institutes. As expected, there is no significant difference between success ratios of deviation from laws before and after compulsory rotation before and after compulsory rotation period for them. Confidence level of 95% for mean differences between two test and control groups in a positive and negative interval also confirms this claim. Therefore, it can be said that there is no significant relationship between compulsory rotation of the auditing institutes and deviation from laws and this change has no significant effect on success ratios of deviation from laws. Therefore, the third research hypothesis is not accepted.

Testing the fourth hypothesis: There is significant relationship between compulsory rotation of auditing institutes and accounting mistakes discovery.

Table 6- Results of testing paired mean comparison of the fourth hypothesis for the test and control groups

Confidence interval of 95%		Significance level	Degree of freedom	t statistic	Number of companies	Paired variables	Group
Upper limit	Lower limit						
0.1191	0.0038	0.039	55	2.115	50	**Mean success ratio of accounting mistakes discovery before and after change**	**Test**
0.1156	0.0179 -	0.149	55	1.465	50	**Mean success ratio of accounting mistakes discovery before and after change period**	**Control**

Considering that the obtained significance level is below 0.05 for the test group, hypothesis H_0 regarding equality of mean success ratio of accounting mistakes discovery before and after rotation of the auditing institutes is rejected in confidence level of 95% and it can be concluded that mean success ratios of the discovered alterations of two populations are not equal

and it means that compulsory rotation of auditing institutes of the test group has been effective on success ratio of accounting mistakes discovery by the auditing institutes. Considering that the upper limit (0.1429) and lower limit (0.0038) are positive, it can be concluded that mean success ratios after compulsary rotation of auditing institutes is higher than mean success ratios before it, therefore, it can be said that compulsary rotation of auditing institutes increased success ratio of the auditing institutes in mistakes discovery, therefore, the fourth hypothesis of the research is accepted. The significance level of the control group which is higher than 0.05 indicates no significant change in success ratio in similar time periods for the control group.

Testing the fifth hypothesis: There is significant relationship between compulsory rotation of auditing institutes and accounting procedures discovery.

Table 7- Results of testing paired mean comparison of the fifth hypothesis for the test and control groups

Confidence interval of 95%		Significance level	Degree of freedom	t statistic	Number of companies	Paired variables	Group
Upper limit	**Lower limit**						
0.1644	-0.0543	0.318	55	1.008	50	**Mean success ratio of accounting procedures discovery before and after change**	**Test**
0.0491	-0.1092	0.450	55	-0.761	50	**Mean success ratio of accounting procedures discovery before and after change period**	**Control**

Table 7 shows that the obtained significance level is above 0.05 for the test and control groups that is hypothesis H_0 regarding equality of mean success ratios of accounting procedures discovery in two groups is not rejected. Therefore, it can be concluded that there is no significant difference between success ratios of accounting procedures discovery before and after compulsory rotation of the auditing institutes. As expected, there is no significant difference between success ratios of accounting procedures discovery before and after compulsory rotation period for them. Confidence level of 95% for mean differences between two test and control groups in a positive and negative interval also confirms this claim.

Therefore, it can be said that there is no significant relationship between compulsory rotation of the auditing institutes and accounting procedures discovery and this change has no significant effect on success ratios of accounting procedures discovery. Therefore, the fifth research hypothesis is not accepted.

9 CONCLUSION

Results of the research show that rotation of auditing institutes had significant relationship with declared and diagnostic tax distinction and accounting mistakes so that rotation of auditing institutes significantly increased success ratio of declared and diagnostic tax distinction and success ratio of the accounting mistakes discovery compared with the period before compulsory rotation of the auditing institutes and this shows that rotation of the auditing institutes increases auditing quality considering declared and diagnostic tax distinction and accounting mistakes. On the other hand, significant relationship was not found between rotation of auditing institutes and accounting estimates discovery, deviation from laws and accounting procedures.

In general, considering the obtained results, the auditing institutes are suggested to change periodically in companies to keep independence of the auditing institutes. Many legislators believe that long-term relations of auditor and employer reduce supervisory power of auditor and auditing quality, therefore, reduction of duration of the auditor and employer relation increases independency of auditor and increase in independency of auditing institutes can increase auditing quality.

REFERENCES

[1] D. L. Moore, "Forecasting earnings management: Evidence from GAO restatement data", *Doctoral Dissertation*, Touro University International,2007

[2] J. Azibi , H.Tondeur , M. Rajhi , "Auditor choice and institutional investor characteristics after the Enron scandal in the French context", Crises etnouvellesproblématiques de la Valeur, Nice: France,2010

[3] M.A. Aghaei , H. Zalaghi. H . Etemadi , E.A .Anvari Rostami, "Effect of restatement of financial statements on quality of the accruals". Accounting Experimental Researches. Second year. No. 7, Pp. 119 -147. 2013

[4] GH. R. Kordestani , A. Azad , M. Kazemi, "Experimental test of Importance of yearly adjustments in capital market". Accounting researches. No. 8. 2010

[5] U. Hasas Yeganeh and V. Jafari , "Effect of rotation of auditing institutes on quality of auditing report of the companies listed in Tehran Stock Exchange". Stock Exchange Periodical. No. 89, third year. Pp. 25-42. 2010

[6] L.E. De Angelo, "Auditor Size and Audit Quality". Journal of Accounting and Economic. Vol3.no3. pp.1.1981

[7] A. Esmaeil Zadeh Mogheri, M. Z. Jalili and A. Abbas Abadi , "Studying effect of corporate governance on earning quality in Tehran Stock Exchange". Management Accounting Journal. Third year. No. 7. 2010

[8] U. Hasas Yeganeh and R.Baghoomian , "Corporate governance and quality of financial reporting". 2005

[9] Technical Committee of Auditing Organization. Principles and Rules of accounting and auditing, Accounting Standards. Auditing Organization. Publication No. 160.2007

[10] G. Nashwa , "Auditor Rotation and the Quality of Audit". The CPA Journal, pp.22-26.2004

[11] E. michael & et."how do restatements begin? Evidence of earnings management preceding restated financial reports" journal of business finance & accounting.2010

[12] M. Hirschey, KR. Smith, and M. Wilson.(2013). "The Effect of Restatement Detection Speed on Reporting Credibility ". Working paper. *Texas Christian University - Department of Accounting*.2013

[13] D. li, "Does auditor tenure affect accounting conservatism? " Further evidence. J .Accounting. Public policy29, 226-241,2010

[14] V. Mojtahed Zadeh and P. Aghaei , "Factors affecting quality of independent auditing from the viewpoint of independent auditors and users". Accounting and Auditing Studies Periodical. No. 38. P. 53.2004