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## A CONTRASTIVE ANALYSIS OF INDEPENDENT AUDITOR TENURE IN DISTRESSED AND NON-DISTRESSED FINANCIAL COMPANIES ADMITTED IN TEHRAN STOCK EXCHANGE

Ali Bastami

**Abstract:** Companies are continually looking for profit making and wealth. However, some companies are not able to carry on activities and fulfill their commitments up to a predictable time in future. Therefore, the sources which could be invested on profit-making chances are wasted away and in a broad view will play a negative effect on macro-economic indexes which all indicate financial distress (ambiguity on activity continuity) of the companies. Then, if an independent auditor comes to the conclusion during his tenure that the company's future activity is unclear, it must be stated in auditing report to avoid misleading the user of the financial reports.

Therefore, present paper is an attempt to investigate whether there is a meaningful difference between independent auditors tenure in financially distressed and non-distressed companies.

In other words, can auditing be a factor to avoid a company's financial distress? In order to analyze the data mean comparison of two populations and in order to make meaningful the regression coefficient t-student test were used. In order to check the normality of data kolmogrov- Smirnov test was used.

Based on the investigations it was concluded that in financially non-distressed companies tenure is longer than financially distressed companies. In other words, as an independent auditor's tenure increases, it can be a factor to predict companies' studies. Comparative analysis of independent audit tenure in distress and non-distress financial companies accepted in Tehran stock market.

**Keywords:** Auditor Tenure, Distressed and Non-Distressed, Financial Companies, Tehran stock Exchange (TSE)

### INTRODUCTION

Corporations first came into existence in England to carry on occupation, limited charges of shareholders and transferability of shares among which transferability of shares led to the emergence of stock market. Investors surely need reliable information in stock market which leads to the emergence of auditing. Since the purpose of auditing is to improve financial report (Baniet al., 2010) planning and running proper auditing and demand to auditing enjoys considerable importance among users especially among investors. However, big companies financial reports and lack of sufficient information on distress in financial reports and auditing reports in one hand and increase in the number of fake financial statements and auditing on the other hand leads to concern on companies auditing and damage to the credit of auditing and accounting (Nikoomaram, 2009).

One other critical issue is that if companies predict that in a certain future they will suffer from financial distress (obscurity on activity continuation) there must be enough disclosure so that financial reports and auditing reports users could get clarified using the information and make reasonable decisions (auditing standards, 1388). Accounting and auditing have adopted options on changes in standardization processes from traditional process to rule-governed or both in compiling auditing and accounting standards to create options and to get financial report and auditing reports users' trust and also have emphasized

auditors independence (Nikoomaram & Nadavar, 2009). Several studies have been conducted on auditing tenure program but no study has exclusively investigated the issue. That is why the researcher has investigated independent auditor tenure program in distress and non-distress financial companies comparatively in Tehran stock market.

This paper could be used to underline auditor tenure program and whether auditing tenure could be a factor to avoid companies' financial distress or no.

Research question is that "Is there a significant difference between independent audit tenure in financial distress and non-distress companies in Tehran stock market?"

### Research hypothesis is:

There isn't a significant relationship between independent audit tenure in financial distress and non-distress companies in Tehran stock market.

Participants include all admitted companies in Tehran stock market during the period of 2002 -2009. The existence of some non-congruities among admitted companies in Tehran stock market led to specific conditions to be considered on how to sample the companies which follow.

1-The sampled companies should be in admittance in Tehran stock market since 2002.

2-They shouldn't change their financial period and their fiscal year should end to march 18 (In Persian Date Isfand29).  
3-They shouldn't be among investor and /or financial brokers.

The selected sample includes 78 distress and non-distress companies from 2002-2009 that met the criteria and were selected based on systematic crossing out.

#### **METHODOLOGY:**

Since the main objective of the present paper is comparative analysis of auditor tenure in distress and non-distress financial companies in Tehran stock market, so the methodology is a comparative one and since financial reports were used to collect the data, the methodology is post – event.

#### **Definition of keywords:**

##### **Financial distress:**

Companies are called to be financially distressed that have problems in returning their debts and are not efficient enough to cover expenses and are subject to commerce act 141. Based on the act if the company loses half of its capital because of losses the boards of directors are in charge to hold the emergency general meeting to vote on existence or dissipation of the company. If the assembly does not vote on the company's dissipation, they should decrease the amount of capital to current capital, based on act 6.

The present paper discusses financial distress in three levels based on Altman's model; in other word, Concealment inability in paying debts and total bankruptcy (Jabbarzadeh et al., 2009).

Auditor tenure is a criterion to evaluate auditing quality which evaluates and audits an employer during the year of auditing.

## **2. LITERATURE**

The process of auditing an employer could be better conducted by an auditing institute in a period of successive years because of their familiarity with employer's auditing operations. If the auditing institute has the experience of auditing the employer's company for several years, the auditing will both have an efficient knowledge on the employer's function and will accelerate auditing operation, decrease auditing expenses and improve auditing quality. Results from foreign countries show that a prolonged auditing tenure leads to better understanding and skill in auditing and improving auditing quality. Mires et al., (2003) Reported that the longer an auditor works for an employer the more efficient the quality of reported profits are. Johnson et al., (2002) found that the longer an auditor's tenure is, the more efficient the quality of profits (its stability is evaluated based on committed items) is. Carslo and Naghi (2004) and Falateh (2006) applied auditor tenure as an evaluating index in auditing quality in their studies about auditing quality. They considered the limit of five years for auditing tenure.

Although, Nancy et al., (2004) considered auditing tenure of 3 years in his study. (Carslo & Naghi, 2004; p655)

In the present paper, considering the former studies, the researcher considers tenure of less than an equal and more than Five years, respectively. For the companies with tenure

of five years or more the value is one and otherwise it is 0.

## **REVIEW OF THE RELATED LITERATURE**

### **Foreign studies:**

Among studies in each of the variables one can refer to Knechel et al., (2007) studies. In their study, they evaluated the influence of auditor's tenure on auditing quality by inspecting the information about some bankrupt and non-bankrupt companies and considered ideas on activity continuation as an index of auditing quality. Their results showed that auditors in a short tenure neither get more independent nor could better understand bankruptcy. They believe that short term tenure does not improve quality. Normand et al., (2009) has studied the probability of discrepancy in auditing committees' characteristics among distress and non-distress financial companies in Malaysian stock market. They found that companies' distress has a negative relation with auditing quality and economic and financial knowledge of auditing committee. Carcello et al., (2004) has investigated the relationship between auditor tenure and fake financial reports. Their studies indicated that the number of fake financial reports in the first three years was more than following years. They believe that volunteer change of auditing institute does not improve the quality of financial reports but when auditing tenure is three or less than three years, fake financial reports increase. Shafaei et al., (2009) investigated the relationship between auditing institute tenure and auditors reports quality in stock market companies in Malaysia. Their studies indicated that auditing institute tenure has a positive relationship with auditing report quality, meaning that the more a tenure is, the better the quality of report will be. Moreover their studies showed that the importance of internal monitoring to improve independent function is more than obligatory auditor changes. Boone et al., (2010) investigated the issue whether auditing quality in 4th companies and secondary companies is similar or no. They found that there is little evidence that 4th companies tend to use continuous function theory in auditing regarding distress companies ; Although non-operational commitment items – items which are the index of evaluating auditing quality – are similar in 4th and secondary companies, in general their results showed that there is little difference in real auditing quality between 4th and secondary companies. However, there is considerable difference in their understanding of the concept of auditing quality. Jiang et al., (2010) investigated an issue called the weakness of internal monitoring systems and distribution of convincing viewpoints (function continuity considered). They found that the weaker the internal monitoring systems in a company is, the more the concerns of an auditor will be. The study which followed Sarbinze rule investigated internal monitoring quality in evaluating function continuity of financially distressed companies and found that if weak points of internal monitoring systems are disclosed by sub sets (internal auditor) of a company then (independent) auditor's concern will decrease considerably. Jenkins and Velury (2008) in their study investigated the relationship between an auditor's tenure and conservation in benefit report. They found out that there is a direct relation between benefit report conservation and the length of auditing and employer's relation. In other

words their study indicated that obligatory change of auditors has an inverted influence on conservation of financial reporting. But in Iran no study was found to investigate specifically the mentioned issue.

AmenehBazrafshan (1388-2009)conducted a research titled investigation of relationship between auditor's tenure and conservative benefitreporting in Tehran stock market. They concluded that there is a direct and meaningful relationship between auditor's tenure and conservatism. In addition, through dividing the sample into three groups based on tenure length, they confirmed the former results and observed that conservatism increases along with tenure extension. Generally the results showed that in a short tenure conservatism is low.Then auditor's obligatory change may have an inverted effect on benefit conservatism.

Measurement criteria for independent auditor's tenure

An auditor's tenure is evaluated in a way that if an independent auditor does not change in a period of eight years (81-88)or changes only once point 1,twice changes point 0.67, three times changes point 0.33 and in case of four times or more changes point 0 is consider for the company and then the results are compared.

Based on the conducted studies, Altman's model is more efficiently reliable than other financial distress evaluation models. That's why the researcher has preferred to use it in the present paper to evaluate financial distress of companies.

Altman's multiple assessment model (Z'-score) is as follows:  
Z'= 0.717×1 +0.847×2 +3.107×3 +0.42×4 +0.998×5  
X1=total finance /capital in circulation  
X2=total finance /accumulated profit  
X3=total finance /gross income (income before meeting rate and tax)  
X4=debt  
X5=total finance /total sale  
In this model if:

Z'< 1.33 the probability of bankruptcy is high  
Z'< 2.9 > 1.33 company is on the edge of bankruptcy  
Z'> 2.9 the probability of bankruptcy is low (Jabbarzadehet al.,2009)

3. METHODOLOGY

The basic theory and theoretical data were collected through a desk study from Persian and English books and articles. The needed data to assess the research hypothesis were extracted from several resources including Burse website, research management website Islamic studies and development website and irandoc.dc.ir which then were transferred to EXCEL to be processed. SPSS software was used to assess the hypothesis, In order to analyze the data comparison of means model was used. Moreover, in order to make regression coefficient model meaningful, student t-test was used Kolmogorov – Simonov test was used to test normality of data.

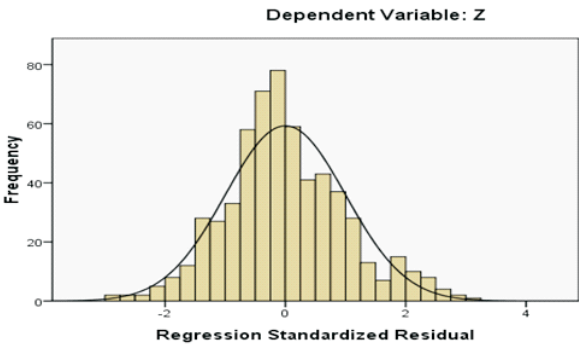
5-4-hypotheses assessment:

The data were tabulated in a year-company model. All collected data from 8 companies in 8 years were tested.Since the number of observations is high, its accuracy is more than cross-sectional (year by year) method Univariatelinear regression model was used to test the hypothesis. Tenure was considered as independent variable and the probability of being distressed or non-distressed was considered as dependent variable. Assumptions which are necessary in a Univariate linear regression model are the normality of dependent variable and lack of self-interrelationship in dependent variable and normality of errors. Watson –camera is used to test self-interrelationship. One of the assumptions of linear regression is the normality of errors.

4. RESULTS

Error diagram is drowning to investigate the normality of error distribution:

Diagram 1: regression error distribution



Regarding normal distribution and mean diagram which is very low and standard error deviation which is very close to one, we can conclude that error distribution is normal and regression a may be used.

Table 1 shows the results derived from Univariate linear regression test for the second sub-hypothesis.

Table1.2nd sub hypothesis assessment

Statistical method : univariot linear regression				
Companies and date of study : 87 companies				
Dependent variable : financially distress or non distress probability according to Altman Z			Confidence level : 95%	
Model total meaning fullness		Watson-camera	R square	Adjusted R square
F	Sig			
11.230	.001	1.906	.019	.017
Significance of each variable		beta	Independent variable	
t	Sig			
-5.462	.000		Constant	
3.351	.001	-.136	tenure	

As it is clear from table 1, the relationship between auditor tenure and probability of financial distress in 78 companies was statistically analyzed through Univariate linear regression model (624 samples divided by 8 years of



research).

Watson's camera number is 1.906 which shows lack of interrelation between errors. Coefficient of determination is 0.019 which shows That 0.19 percent of financial distress probability (dependent variable) can be explained, by changes in independent variable (tenure) and the rest of changes in financial distress probability is explained through elements rather than what was mentioned before, which a shows a weak relationship between dependent and independent variable considering the table, ANOVA model is totally meaningful.

In other words the significance of ANOVA is less than %5, the significance of tenure is also less than %5 which indicates its meaningfulness B number is -0.136 which show regression line slope.In other words,the relationship between dependent and independent variable is weak and inverted,i.e., tenure non-distressed financial companies are longer than distressed companies.

ACCOUNTING INTERPRETATION:

Based on the results one can conclude that tenure in non-distressed financial companies is longer than financially distressed companies which is in accordance with knechel et al., results in 2007.In other words auditor's knowledge about activity,amount of activity and ambiguities in the company increases along with his/her length of tenure and so an independent auditor gets a general knowledge about the company which leads to not only an easier auditing but also a lot of ambiguities specially ambiguity on company's function continuation are relieved.

CONCLUSIONS BASED ON HYPOTHESES:

Considering the results derived from hypothesis evaluation the researcher concluded that independent auditor's tenure in non-distressed financial companies was longer than distressed counter-parts which is in accordance with knechel et al., (2007) studies. Knechel et al., (2007) also concluded that a short-term tenure cannot predict financial distress of companies. Therefore, as auditor's tenure increases, the probability of financial distress decreases in a given company. In other words, companies re-organize to relieve financial distress based on independent auditor's report and annual management letter. In general, as it was mentioned, one can conclude that as auditor's tenure increases, it can be considered a factor to predict financial distress of companies.

Comparison of the results from the present paper and other researches:

correspondence	Results	Results from different studies
yes	Independent auditor's tenure in financially non distressed companies is longer than distressed ones	Current studies results
yes	Tenure in financially non -distressed companies is more than distressed ones	Knetchelet al .,(2007)
yes	Independent auditor's tenure in financially non distressed companies is longer than distressed ones	Norman et al .. (2009)

5. CONCLUSION

2.Based on the conclusions it is suggested that companies should not change their auditors in intervals less than five years to improve prediction of function continuation

(financial distress)

4.The purpose of forming company is continuous activity up to a predictable future.Therefore, based on the conclusions, it is suggested to the managers of admitted companies in Tehran stock market in order to avoid financial distress and ambiguity about activity continuation, they should use auditing organization reports in their annual reports.

Suggestions for further research are:

Comparative study of independent auditor's tenure in different financially distressed and non-distressed companies. (for example car manufacturing industry)  
Investigating the relationship between an auditor's tenure and conservatism in accounting.  
Investigating the relationship between an auditor's tenure and the quality of finance reports in companies admitted in Tehran stock market.

Limitations of the study are:

- The data from companies that were subject to act 141 of commerce low was not accessible.
- The research period was for eight years which through increasing the period one can get more comprehensive results.
- The research was performed only for admitted companies in Tehran stock market while, according to the bills from ministry of finance, non-stock companies whose sales are higher than eight milliard Rials are to report their audit which was ignored in this paper.

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