

Long-term Auditor-client relationship and its effects on the audit quality

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Abstract

Apart from this, the long-term Auditor client relationship has been the center of attention in most of the discussions and debates as well. Numerous studies have been conducted by the academic researchers, financial and professional analysts, regulatory authorities and governing bodies, and in some cases by the Auditors and the firms as well regarding the effects of long-term Auditor-client relationship on audit quality, equity risk premium, financial reports quality, audit pricing etc. These studies provide us with different results, both with the positive and negative associations and effects of long-term Auditor-client relationship on the basis of different factors and contexts.

For long, auditing has been discussed in different studies and research areas but mostly in association with publicly listed companies. Less attention has been paid to the relationship of Auditors and clients as far as clients in SMEs are concerned. In any country around the globe, SMEs are of major contribution in terms of backing the economy, giving it both the boost and the stability, as they collectively form the major chunk of the economy. If we specify our study to the SMEs in Kosovo, then 80% of the enterprises in Kosovo represent the SME sector; in addition they employ around 60% of the manpower. Based on these facts, and due to less attention given to Auditor-client relationship in terms of SMEs, instead of; we have directed our concerns towards the study of effects of Auditor-client relationship on audit quality in SMEs in this particular research study.

Keywords: Long-term Auditor, client relationship, audit quality.

Introduction

Numerous studies have been conducted by the academic researchers, financial and professional analysts, regulatory authorities and governing bodies, and in some cases by the Auditors and the firms as well regarding the effects of long-term Auditor-client relationship on audit quality, equity risk premium, financial reports quality, audit pricing etc. These studies provide us with different results, both with the positive and negative associations and effects of long-term Auditor-client relationship on the basis of different factors and contexts. Our defined objective for this study is to examine how the long-term Auditor-client relationship affects the audit quality in Small and Medium Enterprises (SMEs).

We as the writers of this study have worked last year on research study related to the adoption of IFRS for SMEs. During that research study, we had to interview both the Auditors and the SMEs, and during the data collection process we realized that most of the SMEs either have long-term relationship with their Auditors or intend to have longterm relationship. We the authors of this study took up a debate and discussion regarding the effects of long-term Auditor-client relationship, and we found that both of us were supporting two opposite views, such that, one in the favor of long-term

relationship and the other against it.

The perspective can be determined by the problem and for us to create an understanding of the problem and get the information that the study needs.

Our research question: *"How does the long-term Auditor-client relationship affect the audit quality in SMEs?"* will be studied from an auditing perspective; both practically and theoretically in terms of the prior research related to auditing. Another thing is that since this study focuses on both the Auditors and the clients who use audit services; and heedful of the fact that we are accounting students with plentiful auditing knowledge, we will be undertaking this study specifically from the Auditors' perspective both theoretically and practically.

Long-term Auditor-client relationship and its effects on the audit quality

In reply to the question regarding the long-term Auditor-client relationship and its effects on the audit quality, PERSON X. of U-firm replied that long-term relationship would increase the audit quality due to the fact that the Auditor over his engagements with the client firm across the years acquire great deal of knowledge regarding the business operations and financial information of the firm.

1. Long-term Auditor-client relationship and its effects on the audit quality

According to Anders Mardell, long-term Auditor-client relationship is important for both the audit and the audit quality because Auditor needs time in order to get to know the client firm, its processes, its risks, etcetera. That is the reason why an audit is difficult during the first as compared to the successive years. Thus, at least three to five years are needed in order to provide good audit quality. But Anders Mardell was also of the opinion that extensive long-term relationship could be dangerous as well due to the build-up of too close relationship in between the client and the Auditor, which might affect the independence of the Auditor. To the same question Anders Rinzen answered in such a way that for the SMEs long-term relationship seems much beneficial and works out well as compared to the public listed companies, if the other associated factors like objectivity and integrity are controlled. Thus, being an Auditor Anders Rinzen does not have any issues with the long-term relationship of an Auditor and client because if an Auditor sticks to professional conduct and integrity in an audit engagement then nothing is at risk.

AUDITOR X mentioned that long-term Auditor-client relationship is very useful because there is a lot of learning and experience involved in working with the same client for long term. In this way the Auditor can get knowledge about the firm and understand the thinking of the personnel, which can be used in an audit engagement especially in terms of risk evaluation and calculation. It is part of auditing process to know the person behind the business and develop some kind of audit specific relationship with him. AUDITOR X style of auditing is that he discusses matters with the management during the audit engagement for instance discussing what is happening inside the company, and what kind of situations he has at home, and the kind of relationships or problems he is into in his personal life, which could indirectly help in the audit. Although AUDITOR X has long-term relationship with most of his clients, he always makes sure that it does not affect his audit independence in any

way, and due to that reason he does not play any golf with them (with a smile), or meet them in private. And even if AUDITOR X helps them in giving them private advice he still makes sure that he keeps the auditing separate and distant from it. This quality of keeping the auditing separate from other things develop over the years of experience as an Auditor. AUDITOR X added that he gives such impressions to the clients that they can trust him, share their secrets with him, and tell him whatever is necessary to the audit, and that nothing should be hidden from the Auditor.

1.1. Long-term relationship allowing the Auditors to have much knowledge

Anders Mardell totally agrees with the opinion that long-term relationship between an Auditor and client definitely results in an increase in the knowledge of an Auditor regarding the client firm, which then helps in an efficient and effective audit with good audit quality. Even Anders Rinzen was of the opinion that long-term relationship under the factors of objectivity and integrity would lead to an increased knowledge acquired by the Auditor regarding the client firm over the years. To this question, the answer of AUDITOR X was an absolute yes and that this knowledge developed over the years form the basis for good audit quality. But AUDITOR X is worried about the next generation Auditors who might only look at the books and take into consideration only figures of the client-firms and would not walk an extra mile to get to know the client- firm well and develop good relations.

1.2. Complacency of Auditor due to long-term Auditor-client relationship

Anders Mardell, in his opinions also agree with the prior researches and their study results that as the relationship between the Auditor and the client develops over long period of time the Auditor tends to get more complacent. It usually happens that at certain point of time during the relationship the Auditor feels more attached and close to the company and becomes more relaxed and less independent in his audit engagement. Because of the involvement of complacency factor, Anders Mardell supports the regulation of the Kosovese government regarding the mandatory rotation of Auditor after 7-years. According to Anders Rinzen, it is true that level of audit quality would lower due to long-term relationship between an Auditor and client but it would not decrease to such a level that might be riskier for both the entities. Complacency does come into the action due to build up of relationship but still both the parties would tend to keep it at the professional level.

According to AUDITOR X there is always the risk of complacency due to long-term relationship but the Auditors are trained in such a way that they can handle such situations. But on the other hand if the Auditor knows the person and his personality that the mistake was due to error then the Auditor should look into it and give another thought to it, rather than trying to damage the whole business or career due to a mistake which was due to error. So there should be some human feelings involved in an audit as well, and it should not be solely taken as a hardcore job. The risk to the independence of an Auditor lowers with the time and experience as an Auditor. AUDITOR X based on his more than 30 years experience as an Auditor knows how to avoid the risk of complacency and the risks to his Auditor independence.

1.3. Auditor-client relationship and the bilateral monopoly

Anders Mardell stated that he would not agree with the opinion that there exists any bilateral monopoly in the relationship between an Auditor and client. According to Anders Rinzen also there is no bilateral monopoly in between the Auditor and the client. Even AUDITOR X, was of the opinion that there does not exist any bilateral monopoly in between Auditors and client-firms.

1.4. Success of audit in reducing material misstatements

According to Anders Mardell, the success of an audit in reducing the material misstatements depends upon the good knowledge of the client-firm, which ultimately depends upon the audit planning. An Auditor can develop good knowledge regarding the client firm on the basis of his long-term relationship with the firm and their understandings of the firm. Anders Rinzen's reply was that an audit is not merely successful it is very successful in reducing the risk of material misstatements in financial reports. The audit process, the methods, tools and techniques used in the audit engagement all of them are geared to reduce the risk of material misstatements. According to AUDITOR X, an audit mostly and in most of the audit engagements for sure covers up the risk of reducing the material misstatements, and that is the reason an audit is conduct in first place in order to reduce the risks of material misstatements.

1.5. Uniform level of audit quality over the years

According to Anders Mardell depending on the Auditor-client relationship the audit quality might start deterioration after the span of 7 - 10 years, and might not remain the same. If the members of the audit team, which is part of the audit engagement, were changed annually then there would be some uniformity in the levels of audit quality but if the members of the audit team remain the same over the years then it would be tough to maintain the audit quality over the years. The combination of audit teams makes it easy for the inexperienced members to learn from the experienced members in the team. According to Anders Rinzen, long-term relationship in between an Auditor and client not only results in uniform level of audit quality but it also increases over the years. The reason for this is that each year in an audit engagement the audit team goes through all the basic steps, and that is why it is being complained that audit is an expensive service and that for the same kind of business operations and activities the client has to pay for the audit each year.

According to AUDITOR X, long-term relationship in between an Auditor and client can for sure produce uniform level of audit quality, and for this reason AUDITOR X each year gets new recruited employees to work with him who could provide a new and fresh look to the audit. In this way the risk for reduced audit quality is minimized, and it is not that the reliance is placed over the audit manuals because what is necessary for the uniform level of audit quality is the audit plan. The procedures, tools and techniques used during the auditing are mostly similar and what differs is the understanding of their operations and systems in different companies.

1.6. Role of audit-firm size and brand-name in maintaining audit quality

According to Anders Mardell in reference to the theory mentioned that an Auditor of large-size based on his capabilities and resources would tend to keep the audit quality

higher. On the basis of these resources the audit-firm develops tools and technologies that help in improving the audit quality. Thus, it could be said that large audit firms with big brand-name do provide high audit quality as compared to small audit firms. According to Anders Rinzen, audit-firm size surely matters in maintaining the audit quality because the volume and size does matter in maintaining the competent staff that could provide high audit quality in an audit engagement.

According to AUDITOR X, the audit quality is generally better now a day for the entire audit firms irrespective of size and name, which was very low during the past. FAR and FARSRS in the past has worked a lot in reference to uplifting the quality and standard of auditing in Kosovo. If only the Big4 or Big5 firms are taken into consideration, then of course they have resources to develop the audit process and go forward with it, and educate its employees. Based on these facts the big brand names are considered to better with variety of in-house experts.

1.7 Audit quality during the early years of audit engagement

In reply to this question, Anders Mardell mentioned that the risks of audit failure are higher during the initial years and the audit quality would be low due to lack of knowledge. Similarly during the extended years of audit-engagement also the audit quality might decrease due to increase in complacency. According to Anders Rinzen it cannot be stated that during the early years of audit engagement the audit quality would be lower, it might be that the audit firm does not have the sufficient knowledge about the particular client's business due to which something might be missed. But the Auditors are used to uptake of new audit engagements from time to time, and it is about the audit planning and the audit processes which would define the audit results. Over the years, involvement of an Auditor in different audit engagements, the Auditor knows that in a new audit engagement where he should focus and where he could identify any risks. Thus, it would not be completely true to say that the audit quality is lower during the initial years.

According to AUDITOR X, he is of the opposite opinion and mentioned that during the early years of audit engagement the audit quality would not be low because you are excited about the new audit engagement and want to know more about the client firm, and thus the audit is conducted with much spirit and enthusiasm. AUDITOR X pointed out that during his early years with the audit engagements, he has much more to say during the initial years but there are always certain things, which might be hidden during the early years and would take some time to be discovered. So, it is always good to have new eyes to look at the client-firm, and due to this fact Auditor rotation can be of benefit in order to get fresh look to financial reports. Thus it is not a risk rather it is an opportunity.

1.8. Auditor reputation in terms of perceived competence and perceived independence

According to Anders Mardell, it is absolutely necessary that an Auditor should be independent both in appearance and in reality. In Kosovo, it has been stated in the Kosovese law that an Auditor should be independent, for instance, an Auditor could not own the shares in the company which he is going to audit, which an Auditor might do in some other countries. Anders Rinzen was also of the similar opinion that

Auditor reputation would surely strengthen the audit quality, and vice versa. But A. Rinzen did not have much to say about the perceived competence and perceived independence. According to AUDITOR X, the Auditor reputation matters a lot in terms of perceived competence and perceived independence.

1.9. Effects of audit on the information credibility and information quality

According to Anders Mardell, an audit definitely affects the information credibility and information quality of financial reports. Anders explains his views with the help of an example that if a local bank in Pristina knows which of the three Auditors is more credible and reputable then financial reports signed by that Auditor would for sure be of more value to their assessment because they would be sure that the financial reports signed by this specific Auditor are presenting true and fair picture. According to Anders Rinzen if the audit firm is highly reputable, highly respected with large size then it provides some level of comfort in terms your opinion and signature providing the information credibility and information quality. According to AUDITOR X also an audit increases the information credibility and information quality of financial statements.

1.10. Perception of investors and information intermediaries about long-term relationship

According to Anders Mardell, stakeholders' especially financial analysts do not pay much interest towards who has been auditing the client firm; rather it should be the audited financial report, which should stand out for the client firm. Anders Rinzen regarding this question did not have much to say, as he was not so sure about the exactness of the perception of investors and information intermediaries. According to AUDITOR X, the information intermediaries e.g. banks and financial analyst's concern is with the audited financial reports and they would not pay so much attention to the specific names of the Auditors that it has been signed by whom, as they do not know if the person who has signed this document can be trusted or not.

1.11. Overcoming the issues of agency problem due to long-term relationship

In Anders Mardell's opinion, as for the small firms the ownership and the management is one and the same thing, an audit would not make much difference. Where as in big firms, the Auditors very rarely meet the owners and it is mostly the management with which the Auditors work with and develop the understanding and the long-term relationship. So it would not be true to say that an audit could help in completely overcoming the issues of agency problem. According to Anders Rinzen, for the large clients the long-term relationship in terms of overcoming the agency problem does not matter because it is mostly the audit committee that the Auditor meets and reports. Thus, the Auditor in such firm neither gets into direct contact with the shareholders or the management of the firm. According to AUDITOR X, as he mostly works with the SMEs, so he is not sure if he could answer this question properly because the ownership and the management in the SMEs is mostly the same.

Conclusions

This research study was taken up in order to study the effects of long-term Auditor-client relationship on audit quality. Although the effects of the long-term relationship were limited to the audit quality, the research topic still seemed to be broad and obscure. Apart from this less attention has been paid in the previous research on the relationship between audit-client tenure and audit quality in small and medium-size enterprises (SMEs).

The results from the finding of this study shows that although majority of the respondents were in favor of long-term Auditor-client relationship and that it is favorable for the audit quality, some of them in their answers to specific question did mention that certain risks that may lower the audit quality exist in the long relationships.

The overall research study concludes that in case of SMEs, long-term Auditor-client relationship is beneficial, if the risk of Auditor independence and the risk of complacency which might develop during the relationship can be avoided or minimized.

Even the Auditors who were in favor of long-term Auditor-client relationship at some point favored the idea of rotating the Auditors for the client-firms after certain period of time due to the risks of complacency and independence associated with the long tenure.

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