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Exploring the Impact of Auditor Tenure on Audit Quality: A Study of China's Audit Practices

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ABSTRACT

This study empirically examines the relationship between auditor tenure and audit quality, adopting a positivist stance and a deductive research approach. A quantitative methodology is employed to explore this relationship within the context of the Chinese audit market, which implemented mandatory audit rotation policies in 2004. The research investigates the trade-off between two competing dynamics: on one hand, the enhancement of auditor independence and objectivity through mandatory rotation, and on the other hand, the effectiveness and efficiency derived from auditors' accumulated knowledge and long-term familiarity with their clients. The findings reveal a positive and significant relationship between audit tenure and earnings management, suggesting that excessively prolonged auditor-client relationships can impair audit quality by reducing auditor independence. This highlights the critical role of mandatory auditor rotation policies in safeguarding audit integrity and mitigating risks associated with extended tenures. Furthermore, the study examines the influence of additional firm-specific factors on audit quality. It finds that audit firm size and client firm size are negatively, though insignificantly, associated with discretionary accruals, indicating a tendency towards better audit quality for larger entities. Conversely, firm leverage and profitability exhibit a positive and significant relationship with earnings management, underscoring their roles as critical determinants in financial reporting practices.

INTRODUCTION

Research Background

Following notable accounting failures in the early 2000s, such as Enron/Arthur Andersen and WorldCom, regulators worldwide became increasingly concerned about the risks of prolonged auditor-client relationships potentially compromising audit independence and reducing audit quality. In response, numerous countries have taken steps to strengthen auditor independence by legislating interventions in the auditor-client relationship, including mandatory auditor rotation.

Since October 1, 2006, for example, Australia has mandated auditor rotation, as part of a policy to bolster audit objectivity (Auditor rotation, 2007). Similarly, the China Securities Regulatory Commission

(CSRC) mandates that auditors of companies listed on Chinese securities markets must rotate every five years (Firth, 2012). In the United Kingdom, the U.K. Competition and Markets Authority requires public companies to rotate their statutory auditors after a maximum of twenty years, with a mandatory tendering at the ten-year midpoint, effective from 2016 (PwC, 2016). However, in the U.S., while the Sarbanes-Oxley Act of 2002 proposed mandatory audit rotation, the Public Company Accounting Oversight Board (PCAOB) ultimately decided against implementing it in 2014 (Chasan & Emily, 2014).

Despite these regulatory efforts, the effectiveness of mandatory auditor rotation remains contested. Advocates argue that mandatory rotation can prevent the potential conflicts of interest and loss of objectivity that may arise in long-term auditor-client relationships. Studies such as those by DeAngelo (1981), King (1994), and Carey & Simnett (2006) indicate that extended auditor tenure correlates with decreased audit quality. Monroe and Hossain (2013) further propose that mandatory auditor rotation could enhance audit quality by prompting auditors to issue more independent and qualified opinions, especially for long-term, financially distressed clients.

Conversely, skeptics suggest that mandatory rotation could disrupt the continuity and in-depth client knowledge that auditors accumulate over time, potentially reducing audit effectiveness. Thus, whether mandatory auditor rotation consistently improves audit quality remains an open question that this research aims to explore.

Research Objectives

This study will examine the association between auditor tenure, mandatory auditor rotation, and audit quality in the Chinese audit market, where a mandatory rotation policy was enacted in 2004. Specifically, the research focuses on the balance between auditor independence and the efficiency gained through the continuity of the auditor-client relationship.

China provides a unique empirical setting for this research for several reasons. First, Chinese law requires firms to rotate signing auditors every five years, and audit partners' names must be disclosed in audit reports, unlike in countries such as the U.S. This requirement allows for clear identification of mandatory rotation cases. Additionally, since 2006, audit firms in China must report annual pre-audit profits for publicly listed clients to the Ministry of Finance (MOF), enabling researchers to examine audit adjustments in reported profits (Lennox et al., 2014).

This study is driven by two main motivations: (1) heightened market demand for improved audit quality following a series of corporate scandals, and (2) a gap in research on the relationship between mandatory audit rotation and audit quality in China, especially given that the disclosure of audit partner names is required in jurisdictions like Australia and Taiwan but not widely studied in the Chinese context.

Research Question

Does auditor tenure have an effect on audit quality in the Chinese audit market?

Research Objectives

A. To investigate the impact of audit tenure on audit quality in Chinese firms.

B. To provide insights into future policy considerations in the Chinese audit market. If mandatory audit rotation proves to have minimal impact on audit quality, regulators may consider alternative policies, such as mandatory rotation of the entire audit firm, to enhance audit independence.

1. LITERATURE REVIEW

1.1 Audit quality

The concept of audit quality lacks a standardized definition, as noted by Krishnan et al. (2013) and Kilgore et al. (2014). This absence of consensus has made measuring audit quality a persistent challenge in academic research. Various proxies have been used to approximate audit quality, with definitions generally grouped into three categories: compliance with accounting standards (Hodgdon et al., 2009; Street

& Gray, 2002), the likelihood of detecting a breach (Beck & Wu, 2006; Defond & Zhang, 2014; Deangelo, 1981), and stakeholder responses reflecting perceived audit quality (Aloke & Doocheol, 2005; Teol & Wong, 1993; Libby et al., 2002).

Stakeholder perceptions, often measured through responses to the quality of financial reports, serve as an indirect gauge of audit quality. When shareholders and other stakeholders lack direct insights into management and governance practices, they rely heavily on the reliability and transparency of financial reports. Consequently, a common approach to assessing audit quality is to evaluate financial reporting efficacy or earnings quality (Behn et al., 2008).

Given the complexity of capturing reporting or earnings quality directly, researchers have developed various proxies. Common dimensions include neutrality (measured by deviations in discretionary accruals), credibility (measured through the association between earnings and market returns), and earnings conservatism. Discretionary accruals and accounting conservatism, in particular, have emerged as primary proxies in the literature (Bing et al., 2014).

Research consistently suggests an inverse relationship between audit quality and discretionary accruals. Since managers may manipulate earnings to serve their own objectives, large discretionary accruals are generally viewed as indicative of low-quality earnings. Lin et al. (2008) support this finding, showing that higher discretionary accruals correlate with reduced audit quality. Francis et al. (2013) found that audit offices with a higher incidence of past restatements exhibit elevated discretionary accruals among clients, indicating a higher risk of audit failures and subsequent auditor litigation. Poor earnings quality, as measured by discretionary accruals, tends to correlate with audit issues, underscoring its value as a proxy.

1.2 Auditor tenure and audit quality

Research generally agrees that the length of the auditor-client relationship can significantly impact audit quality. Consequently, studies on audit tenure are often intertwined with evaluations of audit quality. The debate around auditor tenure typically revolves around two opposing arguments: shorter tenure may limit auditors' familiarity with their clients, while longer tenure may compromise auditors' objectivity.

Studies in this area have yielded mixed findings, showing both positive (Lin et al., 2008; Chi et al., 2009) and negative (Carey & Simnett, 2006) correlations between auditor tenure and the quality of financial reporting. Some research compares the insights of long-tenure auditors with those of new auditors, with inconclusive results. For instance, Gates (2007) found that financial information often inspires greater confidence following audit rotation. However, Aloke and Doocheol (2005) found that debt and capital markets tend to place more trust in long-tenure auditors than in new auditors. Additionally, studies have linked longer auditor tenure to reduced levels of discretionary accruals, suggesting potential benefits for financial transparency (Myers et al., 2003; Johnson et al., 2002).

Moreover, factors such as auditor size, specialization, and tenure have been identified as influential to accounting quality (Krishnan et al., 2013). The IAASB further categorizes audit quality within a triangular model, encompassing outputs, inputs, and contextual factors, emphasizing the multifaceted nature of audit quality. While there is some research on auditor tenure in the Chinese market, few studies adequately explore the impact of China's regulatory environment on audit quality. A robust accounting and audit regulatory framework is fundamental to ensuring audit quality. However, China currently faces challenges in this area, including a fragmented regulatory landscape with multiple agencies and a lack of centralized oversight. This disparity in regulatory strength can lead to variations in audit quality, with regions under stricter regulatory systems likely to achieve higher audit quality compared to those with weaker systems.

Recognizing this issue, this study will examine not only the impact of auditor tenure on audit quality but also the role of regional regulatory differences within China. By addressing both tenure and regulatory context, this research aims to provide a more comprehensive understanding of the factors influencing audit quality in the Chinese market.

2. RESEARCH METHOD

2.1 Research design

This research investigates the causal relationship between mandatory auditor rotation, auditor tenure, the regulatory environment, and audit quality. Guided by its research philosophy, objectives, and approach, the study adopts a mixed-method strategy combining experimental and documentary designs. The experimental component involves hypothesis development and statistical testing to examine the relationships between key variables. The primary hypothesis tested is:

H: There is a negative relationship between auditor tenure and audit quality.

To test this hypothesis, a pooled regression model is employed. The model utilizes audit tenure as the independent variable and audit quality as the dependent variable. Additionally, the research incorporates other factors identified in previous studies that influence audit quality. These include the regulatory environment, audit firm classification, company size, leverage, and profitability. The formula for the regression model is structured as follows, with audit quality measured by the absolute value of discretionary accruals (DA):

- Dependent variable: Audit quality (DA).
- Explanatory variable: Auditor tenure (TENU).
- Control variables:
  - Regulatory environment: Classified into direct-controlled municipalities (DCMs) of China versus other regions.
  - Audit firm: Whether the firm belongs to the Big Four (Big4).
  - Company size: Represented by total assets (Size).
  - Leverage: Measured by the debt-to-assets ratio (Lev).
  - Profitability: Measured using the return on assets (PROFITABILITY).

This approach allows for a comprehensive examination of the interplay between auditor tenure and audit quality while accounting for the influence of contextual and firm-specific factors. By incorporating regulatory distinctions between China's direct-controlled municipalities and other regions, the study addresses the unique characteristics of the Chinese audit environment. Table 1 defines all the research variables. The regression model is contructed as follows:

$$DAC| = \beta 0 + \beta 1\ TENU + \beta 2\ DCM + \beta 3\ AUDITFIRM + \beta 4\ FIRMSIZE + \beta 5\ DEBT + \beta 6 + PROFITABILITY + \varepsilon \quad (1)$$

Table 1. Variables and Description

Coding	*Variables*	*Definition*
|DAC|	Discretionary accruals	Calculated using modified Jones' (1991) model
TENU	Auditor tenure	The duration of time (years) an auditor has consistently worked with a client firm.
DCM	Direct-controlled municipalities	DCM = 1 if the company is from a direct-controlled municipality (such as Beijing, Shanghai, Tianjin, or Chongqing), which are areas under stricter regulatory control by the central government. DCM = 0 if the company is from any other area in China that is not a direct-controlled municipality.
AUDITFIRM	Audit firm	AUDITFIRM = 1 if the company is audited by one of the Big 4 audit firms (Deloitte, EY, KPMG, or PwC). AUDITFIRM = 0 if the company is audited by a non-Big 4 audit firm.
FIRMSIZE	Company size	Total asset
DEBT	Firm's debt	Defined as the proportion of total liabilities relative to total assets

PROFITABILITY	Profitability	The ratio of income before tax to total assets

Source: own

Audit quality is assessed based on the value of discretionary accruals, as outlined by Dechow et al. (1995) and Jones (1991), using the following formula:

+ Value of a_0, a_1, a_2, and a_3 is estimated through the Eq. (2):

$$TAt / At\text{-}1 = a_0 + a_1 (1/TAt\text{-}1) + a_2 [\triangle Rev /TAt\text{-}1 - \triangle Recc /TAt\text{-}1] + a_3 FAt /TAt\text{-}1 \quad (2)$$

Table 2. Illustration for Variables in modified Jones' (1991) Model

Code	*Variable*
TA_t	Net operating income minus (-) operating cash flow
A_{t-1}	Firm's total assets at the end of the last year
$\triangle$Rev	Changes in orperating sales
$\triangle$Recc	Changes in accounts receivables
FA	Firm's total fixed assets
$NonDAC_t$	Non-discretionary accrual

Source: own

+ Value of N*on-discretionary accruals is estimated using Eq. (3) and coefficients a_0, a_1, a_2, and a_3 (Eq.(2))*

$$NonDAC_t = a_0 + a_1 (1/TA_{t-1}) + a_2 [\triangle Rev /A_{t-1} - \triangle Recc /TA_{t-1}] + a_3 FA_t /TA_{t-1} \quad (3)$$

+ Discretionary accruals (DAC) is calculated by Eq. (4):

$$DAC = TA_t/TA_t - NonDAC_t/TA_t \quad (4)$$

2.2 Data collection

The study examines 11 key sectors in China, including technology, healthcare, retail, manufacturing, energy and others. From each sector, 20 companies are randomly chosen, leading to a total of 2,200 companies from the Shanghai Stock Exchange (SSE) and 220 companies from the Shenzhen Stock Exchange (SZSE). Data is gathered over a five-year period, from 2019 to 2023, resulting in a final sample of 440 companies and 5,500 observations.

Notably, the sample includes companies located in direct-controlled municipalities of China, which are subject to stricter regulatory controls. This ensures alignment with location classification requirements, adding robustness to the study's findings.

The research relies on two primary data sources: The first one is Annual Reports: These are used to collect financial data and information on signing auditors, which are publicly disclosed on company websites or via the SSE and SZSE platforms; And the second one is CNINF Database: This official website and database, authorized by the China Securities Regulatory Commission (CSRC), provides comprehensive data access.

3. ANALYSIS AND FINDING

3.1 Data descriptive statistics

Table 3 presents the statistical summary of the chosen sample for this research, covering a five-year period from 2019 to 2023. The lowest audit quality (measured by DAC) in the Chinese stock market during this period is 0, indicating the best possible audit quality. Conversely, the highest value of DAC is 4.338, suggesting that certain companies might have experienced significantly poor audit quality. On average, the DAC value stands at 0.115, which is within an acceptable range and reflects relatively good audit quality across the sample during the observed years.

Table 3. Variable description

Variable	*Min*	*Max*	*Mean*	*SD*
DAC	0.000	4.338	0.115	0.018
TENU	1.000	6.000	2.308	0.042
DCM	0.000	1.000	0.266	0.023
AUDITFIRM	0.000	1.000	0.081	0.019
FIRMSIZE*	6.409	2,078,154	69,703	8,041
DEBT	0.027	6.490	0.488	0.019
PROFITABILITY	-7.005	9.124	0.042	0.035

Source: own
* Million CNY

Audit quality in China over the past five years has significantly improved compared to earlier studies using the same modified Jones model. According to the research by Chen et al. (2008), discretionary accruals were notably higher during the period from 1999 to 2006, with mean and maximum audit quality values estimated at 7.28 and 48.35, respectively. These outcomes imply that recent changes in the regulatory environment and practices have had a positive effect on audit quality.

Furthermore, the tenure range of auditors in the sample spans from one to six years, indicating that most Chinese companies are adhering to the mandatory rotation policy. The inclusion of six years in the range may reflect cases where a one-year cooling-off period has been applied. The mean tenure of 2.308 years aligns with findings from previous research, demonstrating that the average auditor tenure in China typically hovers around three years (Bandyopadhyay et al., 2014).

Table 4 presents the correlations between the variables. Strong correlations are observed between firm size (FIRMSIZE) and audit firm (AUDITFIRM), as well as between firm size (FIRMSIZE) and leverage (DEBT), indicating a potential issue with collinearity. This issue is assessed using the Variance Inflation Factor (VIF) values presented in Table 7. However, since all VIF values in Table 7 are within acceptable limits, it suggests that there is no significant collinearity problem in the model.

Table 4. Correlations Matrix

	DAC	TENU	DCM	AUDITFIRM	FIRMSIZE	DEBT	PROFITABILITY
DAC	1						
TENU	.304**	1					
	0.000						
DCM	-0.007	0.026	1				
	0.389	0.560					
AUDITFIRM	-0.001	0.133**	.217**	1			
	0.977	0.000	0.000				
FIRMSIZE	-0.579**	-0.011	.192**	.538**	1		
	0.000	0.814	0.000	0.000			
DEBT	0.038	-0.002	-0.063	0.012	0.628**	1	
	0.402	0.970	0.161	0.781	0.000		
PROFITABIL-ITY	.613**	0.018	0.010	0.000	0.002	-.407**	1
	0.000	0.691	0.828	0.991	0.964	0.000	
.							

Source: own
Note: **. Correlation is significant at the 0.01 level (2-tailed)

3.2 Result analysis

Table 5 presents the practical application of formulas (2) through (4), culminating in the calculation of discretionary accruals. This step-by-step process ensures the derivation of accurate discretionary accrual values, which serve as a proxy for audit quality in this study.

Table 5. Value of betas in the Eq. (1)

Beta	*Value*
a_0	-0.097
a_1	20.32
a_2	-0.019
a_3	0.541

Source: own

As previously discussed, the regression model includes the dependent variable, discretionary accruals (DAC), one explanatory variable (audit tenure), and five control variables: Direct-controlled municipality classification (DCM) firm size (FIRMSIZE), audit firm type (Big 4 or non-Big 4), return on total assets (PROFITABILITY), and firm debt (DEBT). The regression results, which outline the relationships between these variables and audit quality, are shown in Tables 6 and 7.

Table 6. Model Summary

Model	*R*	*R-Square*	*Adjusted R-Square*
1	.512[b]	0.262	0.266
a. Predictors: (Constant), DCM, TENU b. Predictors: (Constant), DCM, TENU, PROFITABILITY, FIRMSIZE, DEBT, AUDITFIRM c. Dependent Variable: DAC			

Source: own

Table 6 shows that the coefficients of determination for the linear regression results, R-square and adjusted R-square, are 0.262 and 0.266, respectively. This means that 26.% of the variance in the dependent variable, audit quality (DAC), is explained by the six explanatory and control variables included in the model. Overall, the linear regression model exhibits a good fit and is highly significant, with a significance level of 1%.

Table 7. Regression results

Model	*Unstandardized coefficients*		*Sig.*	*Collinearity statistics*	
	B	*Std. Error*		*Tolerance*	*Vif*
(Constant)	-0.536	0.053	0.063		
TENU	0.012	0.029	0.028	0.927	2.100
DCM	-0.106	0.013	1.340	0.903	1.334
AUDITFIRM	-0.222	0.063	0.577	0.837	2.007
FIRMSIZE	-9.43E-09	0.048	0.141	0.714	1.581
DEBT	0.087	0.005	0.019	0.690	1.019
PROFITABILITY	0.256	0.009	0.025	0.752	2.047
Dependent variable: DAC					

Source: own

The results reveal a positive and significant impact of audit tenure on discretionary accruals, indicating that longer audit tenure is associated with higher discretionary accruals, which correspond to lower audit quality. This supports the conclusion that audit tenure negatively affects audit quality, confirming and accepting H1. Regular changes in auditors can help prevent overly close relationships with clients and mitigate the pressure to retain clients, thereby enhancing audit independence, as discussed in the literature review. Similar findings are reported in prior studies, such as Monroe and Hossain (2013), who identified a strong association between audit partner tenure and audit quality using going-concern opinions as a proxy, and Firth et al. (2012), who found a positive relationship between mandatory audit partner rotation and audit quality.

The regulatory environment shows a negative but insignificant impact on discretionary accruals. Companies located in direct-controlled municipalities (DCM) tend to exhibit lower discretionary accruals, indicating higher audit quality. However, this effect is not statistically significant. This finding aligns with Li (2010), which notes a positive relationship between high audit concentration in regulated areas of China and audit quality. Nevertheless, being located in a DCM does not appear to have a significant influence on audit quality in this study.

Additionally, both audit firm (AUDITFIRM) and firm size (FIRMSIZE) exhibit a negative and insignificant relationship with discretionary accruals, implying a positive association with audit quality. Previous research on these factors has yielded mixed results. While the Big 4 are generally perceived as providing higher-quality audit services, Monroe and Hossain (2013) found no strong evidence to suggest that clients of Big 4 firms consistently achieve better audit quality. This may reflect improvements in the audit industry as a whole and the relatively low proportion of Big 4 firms in the sample.

Furthermore, leverage (DEBT) and return on assets (PROFITABILITY) are found to have positive and significant effects on discretionary accruals, signifying a negative and significant effect on audit quality. Higher leverage and profitability appear to be associated with greater discretionary accruals, which can indicate poorer audit quality.

CONCLUSION

In conclusion, this research employs a quantitative methodology to investigate the relationship between auditor tenure and audit quality, while also examining the association between the regulatory environment and audit quality. The findings indicate a positive and significant relationship between audit tenure and discretionary accruals, suggesting that prolonged tenure undermines audit quality. This highlights the necessity of maintaining mandatory auditor rotation policies to mitigate the negative effects of long tenure on auditor independence and quality. Additionally, the study reveals a strong impact of leverage and profitability on audit quality, underscoring their significance as influential factors.

Despite the importance of its findings, the research has several limitations. Firstly, the exclusive reliance on a quantitative approach, consistent with the positivist philosophical stance, may introduce rigidity and limit flexibility in understanding the nuanced cause-effect relationships that could be influenced by human interpretation and judgme. A mixed-methods approach could offer a more holistic understanding by combining quantitative rigor with qualitative insights.

Secondly, the use of proxies for measuring variables presents inherent challenges. For instance, audit quality is often assessed through discretionary accruals, but alternative measures—such as compliance with accounting standards or the likelihood of breach detection—could provide different perspectives. Similarly, profitability can be evaluated through various proxies, such as the return on assets (ROA) or the return on equity (ROE). The choice of proxies, therefore, inevitably involves trade-offs and may not fully capture the complexity of the variables.

To address these limitations, future research could adopt a mixed-methods approach, incorporating qualitative elements to complement quantitative analysis. Furthermore, expanding the scope to include additional dimensions, such as corporate governance practices, could provide deeper insights into the interplay between auditor tenure, mandatory auditor rotation, and audit quality.

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