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Audit firms, audit partners and their impact on audit job: an exploration of the Italian context

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Preface

The purpose of the dissertation below is to advance the research on auditing topics.

This study arises from a deep study of audit job in the Italian context, with its peculiarities and its regulation, and the analysis of the main topics studied by the international literature. Moreover, I made a long hand collection of data on the main accounting and audit aspects of Italian listed firms, for the period 2010-2013.

After the improvement of knowledge on the topics, my supervisor and I developed the research ideas and transformed them in two quantitative analyses, using data previously collected.

The dissertation is structured as follows. After a qualitative explanation of the main features of audit in Italy and a literature review of the main important and noted international studies on them, we develop two quantitative analyses on the sample of Italian firms.

In particular, the first study is an examination of the efficacy of Mandatory Audit firm Rotation in the Italian regime. We observe the effect of tenure length on fees paid to the incumbent auditor and a direct association between tenure and quality.

The second quantitative study is focused on the partner's role in an audit engagement. In particular, we examine the effect of partner behaviours on audit job, when partner seniority increases; specifically, we draw on some peculiar cultural characteristics that epitomize the Italian context, such as the power distance and the gerontocracy.

In the following of the study, we explain all the assumptions and the analyses in depth.

Chapter 1

Audit job and Mandatory Rotations: the peculiarities of the Italian Context

Abstract

The aim of the study is to analyse the audit market in Italy and its legislative and cultural peculiarities. In particular, we analyse what are the reasons underlying the application of some laws in the Italian context, such as Mandatory Audit Firm Rotation and Mandatory Partner Rotation. After, we review extant literature on the impact that these two rules have on the two most important units that are involved in the audit job: 1) the audit firm; and 2) the audit partner. Drawing on this literature review, the study offers some intriguing insights that might convey food for thought for scholars as well as for regulators.

Keywords: Mandatory Audit firm Rotation, Mandatory Partner Rotation, Italian context, audit quality, audit fees

1. Introduction

An external audit is an independent examination of the financial that an audit firm usually conduct for statutory purposes. The main objective of auditor's job is to safeguard to the reliability of firm's financial report and the absence of material misstatements to the external market. To achieve this objective, an auditor should try to convey an information about financial and economic situation of the audited firm, that is as much transparent as possible. At the same time, the expression of a correct audit opinion does not involve only the use of quantitative techniques that aim to test the truthfulness of numbers that are reported in the financial statements of the audited firm. Indeed, the use of qualitative approaches might also allow to shed light on the information quality that is used in the financial statements.

Moreover, in last years a number of scandals, such as Enron, Worldcom, Parmalat, have affected financial markets, thereby generating a lack of trust in mechanisms regulating audit activity. As a consequence, in order to improve the reliability on audit job, several rules and regulations have been introduced in the countries where the audit job takes place. One of the contexts in which the audit job assumes particular relevance is the Italian context. Accordingly, the external audit carries out an important role in the market where Italian operate. Although its regulation is more recent than other countries, Italy is one of the few countries with a strong and restrictive regulation. In fact, conversely to most of other countries, Italy has simultaneously adopted two strong rules that have strictly regulated the auditor job for several years: 1) Mandatory Audit firm Rotation and 2) the Mandatory Partner rotation.

Given the relevance that audit job assumes in the Italian context, the aim of this study is to analyse the Italian audit market and its legislative peculiarities. In particular, in this study we try to understand whether changes and developments in the Italian regulation have positively

influenced the audit job in a way to lead a more efficient audit market. In doing so, we focus our attention on the two most important units that are involved in the audit job: 1) the audit firm and 2) the audit partner.

Specifically, in order to understand the legislative choices of Italian regulation, we believe it is necessary to examine some structural and cultural aspects that epitomize the Italian context. Indeed, several previous studies (Bik and Hooghiemstra, 2017; Dickson et al., 2003) show that internal aspects of a market, such as its organizational structure and its culture, have a strong influence on people, their behaviour and their professional outcomes.

For example, the structure of the Italian context is characterized by the prevalence of family and small firms. The paramountcy of these firms in the Italian context makes Italy different with respect to other countries, such as the American one, in which there are several large firms with a wide dispersion of ownership. From an auditing point of view, in Italian firms the management role that takes place in Italian firms is very important as firms' managers are responsible for the instalment and the maintenance of firms' relationships with auditors.

Moreover, Italy is a country in which cultural and historical aspects are very important. Indeed, the key dimensions of national culture are pervasive in individual behaviours.

One of these dimensions has been identified by Hofstede's study (1983). In this study, the author found that Italy is a country with a high level of "power distance". In this situation, a leader is willing to protect his power by creating barriers that impede other people of the firm to develop their skills and to achieve leading positions.

Consequently, the search of individual power and the successive maintenance of power distance constitute the fertile ground for the relevance of another important and pervasive characteristic of the Italian context: the gerontocracy. Accordingly, some studies (see, among others, Catani, 2014), are focused on the difficult and slow generational change that

characterize leading positions in the Italian context. Indeed, these studies argue that a leader with strong "attachment to the seat of power" affects the generational change in the firm. In fact, his intentions to keep the power for a longer possible period prevent other people to take part in the decision maker process of the firm. As a result, it is not a surprise that the firm's decision-making power resides in the hands of older and more experienced people.

In the audit market, this means that a partner is old and he probably has the maximum level of competence and experience. Moreover, he maintains a power distance with people in minor positions and tries to improve his power in the market.

In our opinion, the provision of both the Mandatory Rotations could be a consequence of the existence of these characteristics and their influence on individual behaviours and professional outcomes. In fact, these rules are provided in order to have a frequent turnover of audit firms and partners. The assumption is given by the necessity to guarantee a full independence of external auditors and the belief that a long connivance between auditors and their clients may create an over-confidentiality between the parts.

However, we pose a question on the real efficiency of these rules and if actually they can avoid problems as the creation of close relationships between the parts or the search of power by individuals.

In order to address this question, after a depth analysis of the Italian legislative framework and the principle rules of audit activity in Italy, we provide a literature review of extant studies that analysed the efficacy of Mandatory Audit firm Rotation and Mandatory Partner Rotation. More specifically, in order to have a general overview we start from analysing the international literature. Then, our analysis moves to those studies that are focused on the Italian context, in order to offer some intriguing suggestions for successive studies that aim to analyse this context. We believe our study may have implications for future research and regulatory development.

The remainder of the paper is organized as follows. In the next section we provide a crystallized understanding of the features that characterized the Italian audit organization and regulation, from 1975 to now. Then, we present a literature review of the main important studies on the topics analysed. Finally, we draw the conclusions.

2. Italian audit organization: the legislative framework

In order to have a clear and general overview of the Italian audit organization and regulation, we explain below the main important aspects that epitomize the Italian audit organization.

According to the current legislative framework, in Italy two types of firms can provide audit services: 1) firms listed in the Italian "Registro Unico dei Revisori" (D.lgs. 39/2010) and 2) some other firms, called trusted firms (L. 1966/39). Among these, only audit firms having publicly listed firms as clients are subject to the control from an external entity, that is Consob. Its control regards the assurance of audit independence and quality. For this purpose, Consob is mandated to require information to audit firms, as well as the transmission of documents and reports. Moreover, it can carry out inspections and checks in audit offices (ex art. 161 TUF, D.lgs. 39/2010).

However, despite the most important task for auditors is to safeguard transparency to the external market about firms' financial reports, they can conduct this task by making discretionary choices, which are affected by their experiences, competencies and relationships. Therefore, it can lead to non-homogenous final results.

Consequently, policy makers have spent several years to create some unique standards for all audit firms. In fact, several laws have been designed during the last century.

Although the Law n. 1966/1939 was the first one to introduce auditing in Italy, the external audit became mandatory with the d.P.R. n. 136/1975, even if only for listed firms. The principle of "Mandatory Audit firm Rotation" was introduced, thereby providing a limit of maximum 9 years for audit firm engagement. In particular, the Law states that an audit firm engagement can have a duration of three years, it can be renewed for no more than two times and it can be reassigned to the same audit firm only after a lapse of five years (this rule is called "cooling-off period").

In 1998, a new legislation modified the rules on audit activity. The introduction of D.Lgs. n. 58/1998, called *Testo Unico della Finanza* (hereafter TUF) repeals the d.P.R. n. 136/75. However, the regulation on Mandatory Auditor Rotation remains unchanged. At the same time, the TUF does not provide a regulation on Mandatory Partner Rotation.

However, the bankruptcy of Parmalat in 2003 shows the importance of this rule, and how the lack of partner rotation may neutralize the function of firm rotation. Therefore, in order to "protect the savings" a new change occurred in legislation (D. Lgs. n. 262/2005). For the first time from 1975, a partner rotation every six years was introduced (art. 159). Moreover, the decree stated the duration of an audit firm engagement for a maximum of 12 years.

After, with the D. Lgs. n. 303/2006, the auditor engagement goes back to a duration of nine years, even if consecutive and without renewals. Rather, the regulations on partner rotation did not change.

In the same year an European legislation wades into the legal framework of Italian auditing. The European Parliament, with the Dir. N. 2006/43/CE, tried to harmonize statutory audit requirements for European member countries. Accordingly, this legislation emphasized the auditor independence, objectivity, knowledge and competence to effectively conduct an audit job. In particular, the regulation provided for a not renewable appointment

of nine years for the audit firm, a partner rotation every six years and a cooling-off period of three years. Some countries have implemented it.

Italian policy makers, in particular, implement the European Directive in 2010, with the D. Lgs. N. 39/2010, the regulation still in force. The Decree confirms the European rules, providing an audit firm engagement for maximum nine years, with no renewals, but it modifies the rule on partner rotation, bringing it from six to seven years.

Finally, the last regulation was approved from the European Parliament in 2014 (Reg.UE 537/2014). It introduced some changes on audit engagement. In fact, it provided a mandatory audit firm rotation of 10 years, that can be extended to 20 years in case of public competitive bids, and 24 years in case of combined audits. The mandatory partner rotation passes to 7 years. However, the regulation has not yet been implemented by European countries.

In the table 1 we provide a summary of the main Italian regulations explained above.

Table 1: The Italian regulation

year	***Legislative regulation***	
1939	Law 66/1939	The audit activity is exclusively voluntary, performed by audit and trusted firms.
1975	D.P.R. n° 136/1975	The audit activity is mandatory only for listed firms. The mandatory audit firm rotation is appointed. The engagement has a duration of 3 years , and it may be renewed for no more than two times, with a maximum period of 9 years. The regulation also provides a cooling-off period of 5 years.
1998	D.lgs. 58/1998	In the Italian language called “Testo Unico della Finanza” (TUF). The provision about the Mandatory firm rotation remains unchanged, with a limit of 9 years (3 years for 3 times). The cooling-off period is reduced in 3 years.
2005	D.lgs. 262/2005	The duration of engagement becomes six years, with only one renewal, with a max of 12 years.

		It introduces the mandatory partner rotation every 6 years. The cooling-off period remains unchanged (3 years).
2006	D.lgs. 303/2006	The maximum duration of the engagement becomes 9 years, but without renewals. The mandatory partner rotation remains unchanged (6 years). The cooling-off period is still of 3 years.
2010	D.lgs. 39/2010	It represents the implementation of the European Directive 2006/43/CE. As the previous regulation, the engagement has a duration of 9 years, without renewals. The mandatory partner rotation is modified in 7 years. The cooling-off period is still of 3 years.
2014	Reg.UE 537/2014	It is just not implemented by European countries. The regulation provides a mandatory term of 10 years for the audit firm's engagement. It is possible to extend the period to 20 years when there is a public competitive bid, or 24 for a combined audit. The mandatory partner rotation remains of 7 years. The cooling-off period changes in 4 years.

To sum up, several important regulations on audit job have characterized the Italian context over time. The occurrence of such legislative regulations allows us to appreciate the importance as well as the need to investigate the Italian context in a fashion way. In the section that follow, we try to explore the reasons underlying the application of two laws that assume particular relevance in the Italian context, such as Mandatory Audit Firm Rotation. Understanding these aspects might help us to develop a better comprehension of what epitomize the Italian context and make it different from the main part of other countries. To the best of our knowledge, very few studies have used this approach.

3. Mandatory Rotations and their influence on audit job: a literature review

As earlier mentioned, the Mandatory Audit Firm Rotation and the Mandatory Partner Rotation might be a consequence of the influence of certain cultural and structural Italian characteristics, such as the power distance, the gerontocracy and the prevalence of small and family firms. However, such characteristics have an influence on auditors behaviours and outcomes, thereby affecting the full independence of external auditors. Notwithstanding that, to assure a full independence of external auditors, the Italian regulation established a frequent turnover of audit firms and partners.

The purpose of the following review is to provide a comprehensive understanding of the extant literature on this topic.

In particular, we start from reviewing international studies on this topic. This analysis, in turn, allows us to have a general view. Then, moving to the Italian context, we review Italian studies and provide some suggestions that may convey interesting insights for regulators and stimulate future research on this topic.

3.1. Mandatory Audit firm Rotation and its impact on audit job

The international literature on audit firm's role and its impact on audit job is very broad and controversial. In particular, after the main bankruptcies in the USA and Europe, the independence of audit firms has become an important question that has attracted attention from international scholars.

A wide legislative debate in many countries on the possibility of high audit quality through a change of audit firm every fixed period of years has led to an increasing attention of international scholars on the association between audit firm tenure and audit job, with

particular attention on aspects as audit fees and audit quality. The results from quantitative studies are heterogeneous, and often contrasting.

In the international literature, some studies show a positive impact of audit firm rotation on audit quality. According to these studies, auditors with longer tenure are more likely to compromise their independence, both for the overfamiliarity with the firm's management and for their intent to maintain the relationship with extant client.

For example, Davis et al. (2009) found a positive relation between discretionary accruals and auditor tenure, thereby suggesting that audit quality decreases with longer auditor tenure. Accordingly, Cahan and Zhang (2006) show that, in the year following rotation, ex-Arthur Andersen clients have higher level of quality and diminishing abnormal accruals. Moreover, DeFond and Subramanyam (1998), analysed a sample of firms with voluntary auditor rotation and found that discretionary accruals decrease during the last year with the predecessor auditor and generally insignificant during the first year with the successor. By examining listed firms from Taiwan, Chi and Huang (2005) found that an excessive familiarity over the time between auditor and client results in lower audit quality and suggest a better period of auditor engagement of five years. Finally, Dopuch et al. (2001), show that the auditor independence ameliorates with both voluntary and mandatory rotations. Taken together, these studies provide evidence of the positive impact of Audit firm Rotation on audit quality. However, some other studies in the international literature have found countervailing findings. Specifically, some of them have questioned the positive impact of Audit firm Rotation on audit quality by showing that, during the years of auditor engagement, an improvement of audit quality is impeded by the Audit firm Rotation. Notably, some scholars believe that audit firms with limited tenure have not incentives to learn about the clients, thereby resulting in lower audit quality (Arrunada and Paz-Ares, 1997). On the

contrary, audit firms with long tenure have great knowledge of client's business, thereby providing a more efficient audit job.

Accordingly, Myers et al. (2003), analysed the American context and found that higher audit quality is related to longer auditor tenure. As regards the Australian context, Jackson et al. (2008) advocate that audit quality, measured as the propensity to issue a going-concern opinion, increases with audit firm tenure.

Moreover, Carcello and Nagy (2004) found that fraudulent reporting is more likely to occur in the first three years of the engagement, whereas there is no significant positive relationship between long auditor tenure and fraud.

Taken together, a plenty number of studies show that there is a correlation between audit quality and audit firm tenure. However, there are some other studies that pinpoint the absence of association between these two aspects. For example, Johnson et al. (2002) show that there is no evidence of reduced financial reporting quality for longer audit tenure. According to Blouin et al. (2007), there is no significant improvements of quality for firms with extreme discretionary accruals that switch to another auditor. As regards the European context, Knechel and Vanstraelen (2007) state that auditors do not become less independent over time. More specifically, the authors argue that the evidence for tenure on either increasing or decreasing audit quality is weak. Additionally, Ruiz-Barbadillo et al. (2009) indicate that mandatory firm rotation is not associated with improved audit quality for Spanish firms.

Furthermore, several studies have associated audit tenure to the growth of audit fees. In this case, the research recognizes the importance of audit firm rotation on an uncontrolled growth of fees. In fact, many previous studies found a positive relation between tenure and fees while a negative relation after the rotation, due to the practice of low-balling (Simon and Francis, 1988). Accordingly, Hay et al. (2006) argue that audit fees are lower in audits where the auditor is relatively new to the engagement. At the same time, Ghosh et al. (2005) state

that the amount of purchase of both audit and non-audit fees become higher when the length of tenure increases.

As regards the Italian context, although Italy is a very interesting country to analyse because mandatory audit firm rotation is mandated for many years, there are few studies that examine its impact on audit fees and quality. Notably, the underrated research on the Italian context reports mixed findings. More specifically, Cameran et al. (2015) examined the efficacy of mandatory firm rotation in Italy. First, the authors show that, in the last years of outgoing audit firm and the first year of the new audit firm, audit fees are significantly different from fees of other engagement years. In particular, Cameran et al. (2015) found that mandatory firm rotation leads to abnormally audit fees by both outgoing auditors and incoming auditor, thereby suggesting Mandatory Audit firm Rotation is costly for clients. Moreover, the authors argue that the audit quality of Big 4 audit firms tends to be lower in the three years following the mandatory rotation and, generally, it tends to be higher in the last three years.

Corbella et al. (2015), in a replication of the analysis from Cameran et al. (2015), separate Big4 and non-Big4 audit firms and show that the audit quality seems not being affected by the rotation in firms audited by a Big 4 audit firms. Notwithstanding that, the audit quality ameliorates in firms audited by a non-Big 4 audit firm. Additionally, they examine the association between audit fees and audit firm rotation, suggesting that fees paid to the auditor after an audit firm rotation are lower for firms audited by Big4 audit firms and unchanged for firms audited by non-Big4 audit firms.

Given the underrated research on Mandatory Audit firm Rotation and the presence of mixed findings on the Italian context, we believe it could be interesting to develop further studies on the efficiency of Mandatory Rotation in the Italian context, in order to provide increasing evidence on the topic. As example, it could be interesting to analyse a different

period than the previous studies, such as the period of crisis. In fact, it is likely that auditors and firms behaviours and objectives may change in this period.

3.2. Mandatory Partner Rotation and its impact on audit job

In recent years, scholars have started to recognize the importance of partner's role in audit engagements and shifted their focus from audit firms to their partners. In fact, the individual partner is the key decision maker of an engagement: he creates and takes care of the relationship with managers of firm audited, he negotiates with them, he manages the engagement, he directs the audit effort, he interprets the audit evidence and, finally, he issues the audit report (Ferguson et al., 2003). For these reasons, the individual partner is often more important and responsible than the audit firm.

However, the main part of audit research have focused particular attention on the audit firms and their most important aspects, while there is not a broad research on the topic of partner's role and its rotation. Only recently the individual partner has started to gain an considerable attention from international scholars. In fact, some of them have recognized that enlarging the analysis to partner level could provide a better understanding of auditor behaviour (DeFond and Francis, 2005).

Although the controversial regulations in several countries, partner rotation is now an accepted practice in many jurisdictions, and often used as less-costly alternative to audit firm rotation. However, audit research on partner rotation is not wide, especially for the unavailability of data. In fact, very few countries require a disclosed name of partner in audit reports.

As earlier discussed with regard to Mandatory Audit firm Rotation, several international studies that are focused on audit fees and audit quality, present contrasting results.

The impact on audit fees is based on the evidence that the rotation could be costly for clients. Firth et al. (2012) argue that the impact of partner rotation on audit fees may depend on whether the rotation is mandatory or voluntary. Contrasting with these results, Stewart et al. (2016) found a positive association between audit fees and both mandatory and voluntary partner rotation. Bedard and Johnstone (2010) showed higher planned realization rates with longer partner tenure, and lower ones after partner rotation. Therefore, despite new partners invest efforts to gain client knowledge in the first years of the engagement, these investments are not compensated by clients, mainly because clients may change audit firms in response to a fee increase.

Moreover, partner rotation should be used as an assurance for high audit quality. However, also in this case, the results from studies are conflicting.

On one side, some scholars argue that partner rotation leads to high audit quality, because the fresh approach of a new auditor in the firm can avoid an overfamiliarity between partner and his client. Hamilton et al. (2005) state that mandatory partner rotation is a good and economic alternative to firm rotation. In their study, they show that it is associated with lower signed unexpected accruals, in particular for Big5 clients.

Several studies examine a sample of firms operating in the Chinese context,, in which the regulation has mandated both mandatory audit firm and partner rotation. For example, Lennox et al. (2014) found higher quality in the years immediately surrounding partner rotation, but an higher frequency of adjustments in the final years of tenure. Moreover, Bandyopadhyay et al. (2014) show an improvement of audit quality after mandatory audit partner rotation. The evidence from Firth et al. (2012)'s study supports the partner rotation requirement, even if the authors argue that a short cooling-off period seems to be less justified than a longer one.

Moving to other contexts, although they focus solely on the year when partner rotation takes place (based on the five-year tenure rule), Litt et al. (2014) show that audit quality is lower during the first two years after partner rotation, compared to the last two years of the outgoing partner; Daugherty et al (2012) argue that partner rotation provision creates a positive impact on audit quality, even if the accelerated rotation, imposed by SOX, has a negative impact.

On the other side, several different studies do not support these assumptions. Chi et al. (2009), for example, found little evidence that variables measuring audit quality are affected by mandatory partner rotation, while Wang et al. (2015) did not find any evidence of this relation. Moreover, Manry et al. (2008), in a study on firms from USA, show that partner tenure has no impact on audit quality measured by discretionary accruals for larger clients, or for smaller clients with partner tenure less than seven years. Further, focusing on the period in which partner rotation is not mandatory, Carey and Simnett (2006) found the absence of association between longer partner tenure and accruals quality. In parallel, the authors found that longer tenure is associated with lower propensity of issue a going concern opinion and a higher propensity of just beat earnings benchmarks, consistent with deterioration in audit quality associated with long audit partner tenure.

In the Italian context, the research on partner's role is not yet developed. To the best of our knowledge, there is only a working paper on the association between partner tenure and audit job in Italy (Mazza et al., 2016). By analysing the partner tenure horizons, the authors found that clients audited by partners with short horizon deliver lower audit quality than clients audited by partners with longer tenure horizon. Moreover, they found that audit fee decreases with short tenure horizons.

For these reasons, it could be useful to improve the knowledge on this topic in the Italian context. Further research could analyse in depth the efficacy of Partner rotation in Italy.

Furthermore, in recent years the audit research has focused increasing attention on another aspect of the partner's role: the partner expertise. Partner expertise is identified as the possession of knowledge and procedural skills that are reflected in years of audit experience (Bedard, 1993). However, deep expertise is often inseparably tied to individual partners' private human capital. Therefore, it is very difficult to be transferred to other partners or offices.

More generally, partner expertise is considered with a positive meaning. Indeed, many studies have demonstrated that, although they charge higher audit fees, expert partners are more likely to detect and report any irregularities in clients' financial reports (Simunic and Stein, 1987). In this case, the expertise should conduct to an higher level of assurance for the external market, that can be traduced in higher audit quality.

In the international research, one of the most used mean of differentiation in expertise is the auditor specialization. Through investments for specializing in specified industries or size groups, auditors may have more information and may be able to charge high audit fees and to assess high qualitative audit activity.

In particular, with regard to audit fees, Zerni (2012) found that both engagement partner industry specialization and specialization in large public firms are viewed as differentiation strategies, resulting in higher fees for these engagements. Goodwin and Wu (2014) show that the coefficient for partner-level expertise is highly significant and economically important for explaining audit fees, while city and national levels expertise are generally unimportant. In this situation, the investments in the acquisition of ability and competencies are compensated by higher earnings for auditor.

However, at the same time, benefits in audit quality provided from expert audit partners may justify these higher audit fees. Krishnan (2003) found that specialist auditors mitigate accrual-based earnings management more than non-specialist auditors and, therefore, have a

positive influence on audit quality. Carcello and Nagy (2004) provided evidence of positive benefit of auditor specialization in deterring financial frauds. Further, Liu and Simunic (2005) argued that specialization, for both audit firm and partner levels, induce efficient audits for different types of clients. Moreover, the specialization is recognized by financial report users and corporate insiders as an additional value.

We believe it could be interesting to develop a discussion on the partner's role in the Italian context and its peculiar characteristics, through the analyses on partner behaviours and performance and their impact of them on audit job.

4. Conclusions

The purpose of the study is to analyse the Italian audit market and its peculiarities. Specifically, we provide an understanding of the cultural and structural characteristics of the Italian context, in order to understand if they may contribute on the implementation of restrictive Italian audit regulation. We believe that some peculiar aspects of the Italian context, such as the prevalence of small and family firms, the power distance and the gerontocracy may have a strong impact on auditors behaviours. We also believe that the provision of a strong and restrictive regulation could be a consequence of the existence of these characteristics and their influence on individual behaviours and professional outcomes.

Furthermore, we explain the most important moments of changes in the Italian regulation with, in particular, the development of the two most important rules, that distinguish Italy from the main part of other countries: the Mandatory Auditor Rotation and the Mandatory Partner Rotation. The assumption is given by the necessity to avoid some opportunistic

attitudes, especially from the individual partner and his search of even more profits and power in his audit environment, and to guarantee a full independence of external auditors.

The purpose of subsequent literature review on international and Italian studies on the two rules allows to understand their efficacy. We analyse whether these two rules can be considered as an improvement of the two most studied aspects of audit job: audit independence and audit quality.

In particular, first we examine studies from the international literature in order to have a general overview. Then, we describe the point of view of studies on the Italian context, in order to give suggestions for successive studies on the Italian context.

We believe that the study could be a good platform for future research and the development of the regulation, in Italy as in many other countries. We hope other studies may improve the knowledge on these topics, also considering new important aspects, such as the impact of cultural characteristics of the individuals.

The explanation above is a platform that allows us to introduce the quantitative analyses of the dissertation. The results of previous auditing literature on the most treated topics, have suggested to us the development of two different analyses. In doing so, we adopt a quantitative approach, using data of a sample of listed firms from the Italian context over a period of four years (2010-2013), previously collected.

Specifically, in the first quantitative paper of the dissertation we focus the attention on the efficacy of mandatory audit firm rotation and its impact on audit fees and audit quality. The purpose of this study is to show the efficacy of this regulation, also contrasting other similar studies on the topic. The results of the analysis support our hypotheses.

In the second quantitative analysis of the dissertation, instead, we focus the attention on partner's role. More specifically, we analyse the impact of partner seniority on audit job, by examining the effects of some peculiar cultural characteristics, such as the power distance and the gerontocracy, on individual behaviours.

Differently from the study on mandatory audit firm rotation (in which we improve the research with similar analyses of previous studies but with different results) in the study on the partner's role we innovate the research on the topic, through measures never used and aspects of partner's job never considered by previous studies.

In the conclusions of every studies, we tries to give some suggestions for researchers and regulators about some possible improvements of audit activity.

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Chapter 2

Influence of auditor tenure on audit fees and quality: evidence from Italian listed firms

Abstract

We analyse whether the length of audit tenure affects audit quality, in the Italian MAR regime. The purpose is to give clear evidence on the efficacy of mandatory audit firm rotation, observing the effect of tenure length on fees paid to the incumbent auditor and a direct association between tenure and quality. We analyse a sample of Italian non-financial listed firms over a four year period (2010-2013). The analyses demonstrate different and opposite results with respect to similar studies. The first one shows that longer tenure leads to a higher amount of fees paid to the auditor; the second one shows that audit quality decreases when tenure increases, while it is significantly higher in the first years after rotation. Basing on our results, we support the implementation of a mandatory auditor rotation in Italy.

Keywords: Italy; audit quality; audit tenure; audit fees; abnormal accruals

1. Introduction

The European Union has recently approved a law introducing mandatory audit firm rotation (MAR) for public interest entities after a maximum engagement period of 10 years, with the possibility to extend it by a further 10 years where an audit tender has taken place or 14 years where there is a joint audit (Directive 2014/56/EU and Regulation - EU - 537/2014), under the belief that a MAR regime is able to enhance auditor independence.

In the opposite direction, the US House of Congress has voted a bill, in July 2013, that will amend the SOX by prohibiting the Public Company Accounting Oversight Board (PCAOB) from introducing MAR. The PCAOB, in fact, issued a concept release in August 2011 proposing MAR as one way to improve audit firm independence; however, after hearing a series of objections to the concept, it did not formally take any decision.

Furthermore, empirical studies have not been still able to give clear evidence on the effects of a long audit tenure and on whether mandatory audit firm rotation is helpful or harmful, because they mainly analyse settings with either voluntary audit firm rotation or mandatory audit partner rotation (Lennox, 2014).

A MAR regime has been in place in Italy since 1975 (Presidential Decree D.P.R. 136/75), and recently several empirical studies have observed the Italian context to analyse the relation between audit tenure and audit quality under a real MAR environment (Cameran *et al*., 2014; Cameran *et al*., 2015; Corbella *et.al*., 2015).

In this study we focus on the relation between audit tenure on audit quality under the Italian MAR regime, observing the relation between tenure and quality, to consider the "familiarity threat" (Carey and Simnett, 2006; Hussey, 1999), and the effect of tenure on both audit and abnormal fees, to consider the "fee-growth-opportunity" effect (DeAngelo, 1981; Blay and Geiger, 2013; Causholli *et al*., 2014).

To achieve our aim, we analyse a sample of Italian non-financial listed firms over a four year period (2010 - 2013), using the level of abnormal accruals as a proxy for audit quality, and the Blankley et al. (2012) model for the measure of abnormal audit fees.

The Italian context is an useful one, at least for two reasons. First, Italy is one of the few developed countries where a MAR regulation is effective for decades, with several modifications in the attempt to continuously improve the effectiveness of the regime. Second, Italy is a setting where it is plausible to expect a negative impact of audit tenure on audit quality. The Italian context is in fact characterized by restricted shareholder dispersion; in this situation governance mechanisms are less effective and auditor independence may be negatively affected by the circumstance that majority shareholders, who nominate the audit firm, are directly involved in management activities.

The results of the analyses show that, under the Italian MAR regime, a longer tenure brings to higher fees paid to the incumbent auditors; moreover, similar results are shown by the analysis on abnormal fees, demonstrating as, when the tenure is long, the level of fees paid to the auditor passes the expected fees. However, we find a positive relation between audit tenure and abnormal accruals; consequently, when tenure increases, the audit quality decreases; moreover, the results on the first period after mandatory rotation show that the audit quality is higher.

Furthermore, we conduct some robustness analyses on the other different periods of an engagement, that support our assumptions.

Other two recent studies on the Italian context (Cameran et al., 2015; Corbella et al., 2015), has led to conflicting conclusions. In particular, Cameran et al. (2015) state that the audit quality of Big 4 audit firms tends to be low in the three years following the mandatory rotation and, generally, it tends to be higher in the last three years, while Corbella et al. (2015) find that the audit quality improves following the audit firm rotation for the firms

audited by a non-Big 4 audit firm, but seems not being affected by the rotation for the firms audited by a Big 4 audit firm. Both studies report a reduction of fees for the Big 4 audit firms in the year following the rotation, and Corbella et al. (2015) do not find any significant reduction of fees in the year following the rotation for the non-Big 4 audit firms.

Our study reports different and contrasting results with respect to Cameran et al. (2015)'s study, while they are similar to Corbella et al. (2015) results. As in this study, our results support the implementation of a mandatory auditor rotation, because they demonstrate a positive impact of it on audit quality. Moreover, using a different period and a different measure of audit quality, we extend the results on Big4 firms.

In this way, our study contributes to the existing literature by adding another piece of knowledge on the efficacy of mandatory audit firm rotation.

Moreover, our study confirms the importance of considering firms' corporate governance structure while studying the relationship between auditors and clients. Some corporate governance variables show, in fact, an impact on both the audit fees and the abnormal accruals.

The reminder of the paper is organized as follows: in section 2 we describe the Italian context, review the literature and formulate our hypotheses; in section 3 we discuss the research methodology; in section 4 we analyse the results and in section 5 we describe the results of some additional analyses. Finally, in section 6, we draw our conclusions.

2. Background and hypotheses development

2.1. The Italian context

Italy is one of the few developed countries where a mandatory audit firm rotation has been effective for decades. The first regulation was introduced in 1975 with the Presidential Decree D.P.R. n. 136 and prescribed a three year audit firm tenure, with the possibility of reappointment for two additional three year terms. After nine consecutive years, a new audit firm had to be engaged and a five year cooling-off period was needed before the previous audit firm could be reappointed. In 1998, after an omission in the article 159 of the Law of Finance (Legislative Decree no. 58/1998), this cooling-off period became of three years. In 2005, the law n. 262/2005 extended the audit firm appointment to six years, with the possibility of reappointment for one additional six year term. The cooling-off period was clearly confirmed to a length of three years. This law also introduced a mandatory audit partner rotation after six years. The audit firm engagement was further modified the following year (Legislative Decree no. 303/2006), providing for a not renewable appointment of nine years and a cooling-off period of three years. In 2010 (Legislative Decree no. 39/2010) the non-renewable nine year audit firm appointment with the three year cooling-off was confirmed. The new term for partner rotation passed from six to seven years.

With regard to the firms' structure and the corporate governance in the Italian context, it is characterized by a significantly high ownership concentration among non-financial companies. Ownership of a company is often in the hands of one or few individuals or family groups, with the average level of ownership of the major shareholder among non-financial-listed firms of about 52%. Furthermore the Italian stock market contains a high percentage (about 70%) of family-controlled firms, with the controlling families strongly committed to the business and highly involved in the management of their firms. In the case of family-

controlled firms, the average level of ownership of the major shareholder rises to 58% (Prencipe *et al*. 2011).

Firms with strongly concentrated ownership may suffer from a threat on audit independence: majority shareholders, who nominate the audit firm, are directly (or indirectly, through their relatives) involved in the management and reporting activities judged by the audit firm. Also the effectiveness of the presence of independent directors on the Board may be impaired, because in such setting it is quite difficult to classify independent directors as truly independent from management (Di Pietra *et al.*, 2008; Ianniello, 2015; Volpin, 2002).

2.2. Literature background

While scholars supporting the MAR state that it leads to greater auditors' independence and greater audit quality, thanks to the new and fresh perspectives brought by the entrance of a new auditor (Lennox et al., 2014), the opponents argue that it increases the risk of audit failures due to the lack of new auditors' knowledge about the client (Know *et al.*, 2014; Sayyar *et al.*, 2014).

An argument in favor of a MAR regime is linked with the consideration that a client may be a significant source of future revenue for an auditor, and the auditor may be reluctant to put this revenue stream at risk. As DeAngelo (1981) states, in settings with growth opportunities of revenues, the economic bond between auditor and client can arise from the future expected revenues that can be obtained from the client. In particular, an auditor's objective may be related to the possibility to maintain the client in the future, in order to recover the initial start-up costs, including any intentional underpricing ("low balling") used in an attempt to acquire the company as a client; thus, independence may be impaired when the auditor becomes too interested in retaining this future revenue stream.

For these reasons, some empirical studies support the effects of tenure on the expected fees (Blay and Geiger, 2013; Causholli *et al*., 2014).

When the duration of the engagement is not pre-specified, the future revenue stream has not a known expiration, and the desire of the auditor is that it could last as long as possible. In this situation, given the risk to be fired by the client because of a disagreement on some aspect connected with the audit judgement, and to lose the future fees, the auditor could be more inclined to back down from management over the quality of the audit work or the reporting of the financial information. Instead, when the duration of the audit engagement is limited and not modifiable, such as in a mandatory rotation regime, the client's ability to fire the auditor in a controversy would become a relatively meaningless threat (Hoyle, 1978).

For this reason, in order to investigate the effect of the Italian MAR on the audit quality, it is useful to understand whether in Italy, as the length of the relationship between auditor and client increases, the client pays higher fees to the incumbent auditor.

Over the last decade some studies found a positive association between tenure and fees, on one side because of the practice of low-balling and the subsequent attempt to recovery in the following years (DeAngelo, 1981; Rubin, 1988; Simon and Francis, 1988), and on the other side for the higher purchase of non-audit services as the length of tenure increases (Ghosh *et al.* 2005).

A meta-analysis carried out by Hay, Knechel and Wong (2006) supports the conclusion that audit fees are lower in audits where the auditor is relatively new to the engagement, while evidence based on a continuous variable for auditor tenure is less conclusive, unless only high-quality journal are considered. In this case a strong positive relation is found.

Furthermore, the widespread use of "low-balling" implies the need for the audit firm to recover the initial costs through the request, year after year, for higher fees to the client, not

necessarily justified by an increase of the audit effort. As audit tenure grows, the increase of confidentiality should make easier for the auditor to request higher fees to the client.

If it is true, we should observe an increase of the fees over time during an engagement in terms of both total fees and abnormal fees. Thus, we formulate our firs hypothesis as follows:

H1a: *As audit tenure grows, clients pay higher fees to the incumbent auditor*

H1b: *As audit tenure grows, clients pay higher abnormal fees to the incumbent auditor*

The need to recover the initial "low-balling" costs by requesting higher fees over time put the auditor in a position of dependence from the client, who must accept to pay the higher (abnormal) fee. This situation could be justified if it lead to a growth of audit quality.

However, while the literature on the relation between tenure and audit fees are usually convergent, previous studies on the impact of tenure on audit quality often present contrasting results. In fact, some studies find a positive impact of audit tenure on audit quality (Chen *et al*., 2008; Myers *et al.*, 2003; Stanley and DeZoort, 2007), explaining as the achievement of expertise for the auditors, which helps them to better understand clients' business. On the contrary, other studies, such as Carey and Simnett (2006), Dao *et al*. (2008), Deis and Giroux (1992), Gates *et al*. (2007), document that longer tenure reduces audit and financial reporting quality, stating that as the length of tenure increases, auditors are more likely to compromise their independence in the control of clients' choices; this may happen in particular for two reasons: they become "too familiar" with the management of the firm, or they want to retain the client business.

Furthermore, other studies, such as Bell *et al.* (2015), do not find any significant association between tenure and quality or affirm that the evidence for tenure on either increasing or decreasing audit quality is weak (Knechel and Vanstraelen, 2007).

In particular, when the effects of the voluntary audit firm rotation have been observed, the conclusions of the studies often support a positive impact of the rotation on the audit quality. For example, DeFond and Subramanyan (1998) find that auditors prefer more conservative accounting choices during the last year of engagement, especially with firms that are likely to have a higher litigation risk.

Observing long term renewable audit mandate, Vanstraelen (2000) finds that long-term auditor client relationships significantly increase the likelihood of an unqualified opinion or significantly reduce the auditor's willingness to qualify audit reports. She also finds a significant difference between the auditor's reporting behavior in the first two years versus the last year of the audit mandate, showing that auditors are more willing to issue an unqualified audit report in the first two years of their official mandate than in the last year of their mandate. These results take the author to assume that the decision to renew the auditor's mandate is already taken and known to the auditor before he has issued his last audit report within his current mandate. This conclusion is clearly in favor of a mandatory auditor rotation regime.

Drawing on the first hypothesis, we believe that, as time flows and the confidentiality increases, while on one side it should be easier for the auditor to request higher fees, on the other side it should be more difficult to stand over a client's request to reduce the quality of the audit work, not only for "friendship" reasons, but also for the economic bonding established between the parts.

Thus, we formulate our second hypothesis as follows:

H2a: *As the audit tenure grows the audit quality decreases*

H2b: *In the first years after mandatory rotation the audit quality increases.*

3. Research methodology

Our analysis is based on a sample of Italian firms, listed on the Milan Stock Exchange and observed over a four year period (2010-2013). We excluded banks and other financial institutions, because this industry is different for audit fees, financial statements structure and abnormal accruals measurement. The initial sample consists of 920 firm-year observations; of these, 607 observations regard firms listed over the entire period of analysis. Because of unavailability of some data, the final sample consists of 429 observations for the first analysis and 440 for the second one, widely distributed over the industries classified through the first digit SIC code.

Financial data are extracted from the Amadeus database. Data on audit fees, audit tenure and corporate governance are hand collected, looking at each firm's financial statements and corporate governance reports.

In order to test our first hypothesis, we use a model (model 1) that analyses the association between audit tenure and both audit and total fees; then, we make the same analysis with the measure of abnormal audit and total fees.

According to previous studies (Gul *et al.*, 2007; Lim and Tan, 2008), we use two different fee metrics to capture the economic bond between audit firms and their clients: the natural logarithm of audit service fees (logAF), which grabs the level of economic bond resulting from the purchase of audit services, and the natural logarithm of total fees (logTOT), which grabs the total bond created by the purchase of both audit services and NAS.

The second and alternative measure of fees is the abnormal fees. They are defined as the difference between the audit fee paid and the expected audit fee (Knechel et al. 2013). They show the extent of the economic relationship between the auditor and his client, that could decrease the auditor independence (Blankley et al., 2012).

We decide to measure abnormal audit fee applying the model from Blankley et al., (2012)'s study. It regresses logged audit fees on variables representing clients' characteristics, specifically controlling for risk, audit effort and industry; however, we exclude, because of unavailability of data, a variable from the original model, used as a proxy for internal control problem of firms (MATWEAK). Therefore, abnormal fees are measured as follows:

$$LAF = \alpha_0 + \alpha_1 LTA + \alpha_2 CR + \alpha_3 CA\_TA + \alpha_4 ARINV + \alpha_5 ROA + \alpha_6 LOSS + \alpha_7 FOREIGN + \alpha_8 MERGER + \alpha_9 BUSY + \alpha_{10} LEV + \alpha_{11} INTANG + \alpha_{12} SEG + \alpha_{13} OPINION + \alpha_{14} INDUSTRY + \varepsilon \quad \textbf{[1]}$$

where:

LAF= logarithm of fees (audit or total);

LTA= logarithm of end of year total assets;

CR= current assets divided by current liabilities;

CA_TA= current assets divided by total assets;

ARINV= sum of accounts receivable and inventory divided by total assets;

ROA= earnings before interest and taxes divided by total assets;

LOSS= 1 if the firm incurred a loss, 0 otherwise;

FOREIGN= 1 if the firm has any foreign operations, 0 otherwise;

MERGER= 1 if the firm reported the impact of a merger or acquisition on net income, 0 otherwise;

BUSY= 1 if the firm's fiscal year is December 31st, 0 otherwise;

LEV= long-term debt divided by total assets;

INTANG= ratio of intangible assets to total assets;

SEG= logarithm of number of business segments;

OPINION= 1 if the auditor issues a going concern audit opinion, 0 otherwise;

INDCOM= industry fixed effects.

Abnormal fees are calculated as the signed residual of this model. In particular, we use this model to obtain two measures of abnormal fees: the first one using data of only audit fees (ABNLAF), and the second one using data of total fees, composed by audit and non-audit fees (ABNLTOT). They are used as dependent variables for the model testing the first hypothesis.

The model applied to test the first hypothesis is as follows (Appendix A, panel A, reports variable definitions):

$$FEE/ABNFEE = \alpha_0 + \alpha_1 TENURE + \alpha_2 SIZE + \alpha_3 MB + \alpha_4 ROA + \alpha_5 CFO + \alpha_6 LOSS + \alpha_7 LEV + \alpha_8 BIG4 + \alpha_9 MERGER + \alpha_{10} BI + \alpha_{11} CEODUALITY + \alpha_{12} BSIZE + \alpha_{13} BLOCK + \alpha_{14} INV + \alpha_{15} REC + \alpha_{16} YDUM + \varepsilon \quad \textbf{[1]}$$

The independent variable TENURE is measured as the number of consecutive years that the firm has been audited by the same auditor, since the beginning of the engagement.

Moreover, the model employs several control variables, derived from the literature.

SIZE controls for the effect of audit services deriving from client's size (Barkess and Simnett, 1994). MB captures the effect of firm's growth on the purchase of services. We also include ROA and CFO to control for firm performance (DeFond *et al.*, 2002). Firms suffering from poor performance need more professional services, in order to improve their profitability (Firth, 1997). Similar considerations regard LOSS and LEV, as pointed out by

Antle *et al*., 2006. With regard to BIG4, Antle *et al.* (2006) found that BIG4 is positively related to fees, explaining that the services performed by Big4 auditors are more expensive, but probably with more added value than non-Big4 auditors; therefore, we expect a positive relation of the variable with fees.

Empirical evidence from previous studies indicates that firms' reorganizations, through mergers or acquisitions, are likely to increase the demand for professional services (Barkess and Simnett, 1994); we therefore expect a positive association of MERGER with our measures of audit fees.

With regard to the corporate governance variables, prior studies suggest that independent directors (BI) may ask for more audit services, in order to protect their reputation and fulfil their responsibilities (Hay *et al.*, 2008). Moreover, some studies suggest that the increasing power of the CEO (CEODUALITY) could create a close relationship with the auditors and, consequently, an increasing purchase of services (Carcello *et al.*, 2002). Beasley (1996) states that a larger board is less effective in monitoring processes (BSIZE), therefore the external auditor may assess a weaker control environment and may require more audit hours, resulting in higher external fees. The monitoring effect of blockholders may require higher audit effort (BLOCK), leading to higher fees.

In order to test the second hypothesis, we firstly measure the abnormal accruals, as a proxy for audit quality.

Abnormal accruals are commonly used as proxy for earnings management and, consequently, as measure of audit quality. We decide to use unsigned discretionary accruals to capture the quality of an audit. Following prior studies, we use the cross-sectional modified-Jones model (Dechow, 1995) to measure them.

Therefore, for each one-digit SIC code, we estimate the following model:

$$TA_t/A_{t-1} = \alpha\ 1/A_{t-1} + \beta_1\ (\Delta REV - \Delta REC)/A_{t-1} + \beta_2\ PPE/A_{t-1} + \varepsilon$$

Discretionary accruals are measured as absolute value of the residual from the above model.

In order to improve the specification and the power of the model, we adjust for firm performance, as suggested by Kothari *et al.* (2005). In fact, they suggest than non-discretionary accruals are highly correlated with current firm performance.

The above estimation of discretionary accruals is used as dependent variable for testing the hypothesis H2a and H2b in the following model (Appendix A, panel B, reports variable definitions):

$$\begin{aligned} |ABACC| = {} & \alpha_0 + \alpha_1\, TENURE + \alpha_2\, SIZE + \alpha_3\, MB + \alpha_4\, ROA + \alpha_5\, CFO + \alpha_6\, LOSS \\ & + \alpha_7\, LEV + \alpha_8\, BIG4 + \alpha_9\, MERGER + \alpha_{10} BI + \alpha_{11}\, CEODUALITY \\ & + \alpha_{12}\, BSIZE + \alpha_{13}\, BLOCK + \alpha_{14}\, YEARDUM + \varepsilon \end{aligned}$$

[3]

In particular, our explanatory variables is TENURE, measured by the number of years that the auditor has audited the firm's financial statements, since the beginning of the engagement. For testing the hypothesis H2b we substitute this explanatory variable with a variable indicating the first three years of tenure (FIRST_TEN) after the mandatory rotation.

With regard to the control variables, we consider SIZE because larger firms are under increased public scrutiny and it could be more difficult for them to implement aggressive earnings management behaviour. We also include MB, to capture the effect of firms' growth. Firms with high growth rates are usually engaged in practices of earnings management to meet market expectations; we expect that the variable should be negatively associated with abnormal accruals. ROA controls for firm performance; Kothari *et al.* (2005) state that high

firm performance is associated with high discretionary accruals. We include CFO because firms with high cash flows may be more likely to raise earnings management practices (Brown *et al.*, 2001). Furthermore, we add LOSS, to consider a possible difference in earnings management behaviour between loss and profitable firms (Dechow and Dichev, 2002), and LEV to control for a possible positive effect on earnings quality deriving from a stronger monitoring by debt-holders. Previous studies (Krauss and Zulch, 2013) show that Big4 auditors and industry specialists are less likely to allow earnings management than other auditors; therefore, we also include BIG4 variable. Firth (1997) shows that acquisitions are additional determinants of earnings management. Thus, we introduce MERGER to control for possible consequences on discretionary accruals, as pointed out by Ashbaugh *et al.* (2003). Finally, we include corporate governance variables (BI, CEODUALITY, BSIZE and BLOCK), to take into account that when corporate governance is weak aggressive earning management behaviours may increase.

4. Results

4.1. Results of H1 testing

Descriptive statistics of the variables used in the tenure on fee metrics model are provided in table 1, while table 2 shows the correlation matrix. VIF analysis does not show any multicollinearity problem.

(Insert table 1 here)

(Insert table 2 here)

Results of the OLS regressions run to analyse the impact of the audit tenure on audit and abnormal fee metrics are reported in table 3.

(Insert table 3 here)

The estimated models demonstrate a good fit for explaining the effects of the audit tenure on the fees paid for services provided by the incumbent auditors. The analyses on FEE present an average Adjusted R^2 of around 75% and an F value significant at the 0,000 level. The adjusted R^2 for the analyses on ABNFEE are lower (around 10%). The results show evidence that the audit tenure positively affects the fees paid to the auditor, with a strong significance for all the analysis ($p<0,01$ for logAF, logTOT, ABNLAF and ABNLTOT). Hence, we can affirm that the increase of the duration of the audit engagement leads to an increase of the audit fees paid to the incumbent auditor. Our hypothesis H1 is confirmed.

As far as control variables are concerned, the results are mainly consistent with the findings of previous studies. SIZE, measured by the total assets of the firm, is strongly positive and significant in three of four analyses ($p<0,01$); this confirms that the larger is the firm, the higher is the extent of the audit services required by the firm, in line with the existent literature (Frankel *et al.*, 2002). Moreover, positive and strongly significant coefficients of MB show that higher growth opportunities of a firm lead to higher fees for both audit and total services ($p<0,01$). Negative and significant coefficients of CFO show that firms with poor performance tend to pay a higher amount of fees (Firth, 1997). This is also confirmed by LOSS, which is positive and significant in three of the four analyses ($p<0,05$).

Positive and significant coefficients of BIG4 ($p<0,05$) in all the analyses indicate that firms audited by Big4 auditors tend to purchase more services and/or that these services are more expensive.

Firms that carried out mergers and acquisitions during the fiscal year are more likely to purchase higher professional services, as demonstrated by the positive and significant coefficient of MERGER in three of the four regressions ($p<0,01$). In contrast with our expectations, Board Independence (BI) and CEODUALITY are positively associated with total fees offered by auditors.

4.2. Results of H2 testing

To test the second hypothesis we consider the absolute value of the abnormal accruals as dependent variable. Descriptive statistics are reported in table 4 and the correlation matrix is shown in table 5.

(Insert table 4 here)

(Insert table 5 here)

Results of OLS regression tests on the sample are reported in table 6.

(Insert table 6 here)

(Insert table 7 here)

The model shows a good fit for explaining the association examined, with an average Adjusted R^2 of about 46%, in line with the extant literature on the topic, and an F value

significant at the 0,000 level. TENURE shows positive and significant coefficients; therefore, the audit tenure seems negatively affecting the audit quality. These results confirm our hypothesis H2a. Hence, if a long tenure decreases the quality of audit work, an instrument as the MAR could help to improve this situation.

Moreover, the table 7 presents the results on the relation between the first three years of tenure (FIRST_TEN) after mandatory rotation. Supporting our hypothesis (H2b), the analysis shows that when the audit firm changes, the audit quality increases.

With regard to the control variables, SIZE shows significant and positive coefficients, suggesting a more aggressive behaviour of large firms in the implementation of earnings management practices. ROA and LOSS are significantly and negatively related with discretionary accruals.

The results on corporate governance variables are, in this case, in line with our expectation. In fact, BI shows a strongly negative impact on abnormal accruals, demonstrating when corporate governance is more independent earning management behaviours may decrease, and the audit quality increases.

5. Additional analyses

In addition to the analyses on the first period of an engagement (FIRST_TEN), we carried out additional analyses to further verify the possible relation between tenure and both fees and audit quality. In particular, we rerun the OLS regressions using several different measures of tenure, in order to isolate some periods of an audit engagement.

Firstly, in the new regressions we substituted the variable TENURE with a dummy variable (LAST_TEN) that takes the value of one if the audit firm is in the last three years of the engagement and zero otherwise.

Moreover, we also consider only the first year of an engagement (TEN1) and the last year of an engagement (TEN9), the initial and final period of two years (TEN12 and TEN89) and the intermediate period of two years, from the fourth to the fifth one (TEN45).

The results of the analyses strengthen our results.

As regards the impact on total and abnormal fees, the results of the analyses show low fees in the first part or in the first year of the engagement, with negative and significant coefficients; instead, they show positive and significant coefficients in the last periods, or in the last year. A recovery of the fees is observable in the central years of the engagement (untabulated).

Moreover, as regards the impact on audit quality, the analyses on the different periods present similar results, with negative coefficients in the first periods and positive in the last ones. However, results on last periods are sometimes not significant. The results on the impact of the different periods of tenure on audit quality are represented in table 8-10.

6. Conclusions

In this paper, focusing on the Italian context, after testing the association between tenure and fees, we study the impact of tenure on the audit quality. In particular, at first we test whether the number of consecutive years an audit firm has been auditing a firm's financial statements (audit tenure) affects the amount of fees paid by the company, for either total and

abnormal level of services; then, we examine whether tenure has an effect on the quality of the audit work.

From the OLS regressions run on our full sample of Italian firms listed on the Milan Stock Exchange in the period 2010-2013, the results of the analyses show that, under the Italian MAR regime, a longer tenure brings to higher fees paid to the incumbent auditors; moreover, similar results are shown by the analysis on abnormal fees, demonstrating as, when the tenure is long, the level of fees paid to the auditor passes the expected fees. However, we find a positive relation between audit tenure and abnormal accruals; consequently, when tenure increases, the audit quality decreases.

We consider this as an additional support on the usefulness of the Italian Mandatory Auditor Rotation, adopted in Italy since 1975, which obliges a firm to change the auditor once reached the maximum duration of the audit engagement (currently, of 9 years), and reinforced by the dropped possibility of a shorter audit term (3-year or 6-year appointments, depending on the law applicable) renewable up to the maximum duration of the engagement. In particular, it is reasonable to think that the mandatory rotation neutralizes the unfavourable effects that may derive from an unlimited duration of the audit appointment, such us the loss of integrity and objectivity (independence) of an auditor in formulating her judgement, either because of the expectation/desire for future renewals of the contract at higher fees, or because of the familiarity created over time by the increasingly close relationship with the client.

This favourable assessment of the Italian mandatory audit firm rotation is similar to those of other studies using different context. However, it is opposite to studies in the same context, but with different analyses, different periods and different results.

It is interesting to notice that comparing our results with those of Cameran *et al*. (2015) and Corbella *et al.* (2015), contrarily of their results, we find decreasing audit quality with the

increase of the audit tenure, while it is significantly increasing in the first years after mandatory rotation.

From our study it is also clear that corporate governance characteristics have an impact on the audit quality. In particular we find that an higher board size and an higher number of independent directors tend to improve the quality of auditor work.

Given the peculiarity of the Italian ownership structure, and consequently, of the effectiveness of the corporate governance, future research could be profitably focused on these relations.

Our study restricts its focus on the audit firm tenure, living out of the analysis the effects of the change of the audit partner. Future studies may also focus on this topic, considering the Italian mandatory partner rotation after 7 years.

Furthermore, it is still a matter of debate whether the high abnormal accruals found by some studies immediately after a mandatory audit firm rotation (e.g. Cameran *et al*., 2015) are totally a sign of earnings management or, at least in part, accounting adjustments required by the new auditor. Further studies may focus also on this topic.

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APPENDIX A: variable definitions

Panel A - Tenure on fee metrics model

FEE	fee metrics, defined as follows: - logAF is the natural log of audit fees - logTOT is the natural log of total fees, given by the sum of audit and NAS fees.
ABNFEE	The abnormal value of fees, defined as follows: - ABNLAF is the abnormal value of audit fees; - ABNLTOT is the abnormal value of total fees, including audit and non-audit services;
TENURE	number of years that the auditor has audited the firm's financial statements, since the beginning of the engagement;
SIZE	natural log of total assets at the end of the fiscal year;
MB	market to book ratio, equal to market capitalization over shareholders' funds;
ROA	return on assets, equal to EBITDA on total assets at the end of the year;
CFO	cash flow from operations scaled by total assets at the beginning of the fiscal year;
LOSS	1 if the firm reports a loss, and 0 otherwise;
LEV	total debt on total assets at the end of the fiscal year;
BIG4	1 if the firm is audited by a Big4 firm, and 0 otherwise;
MERGER	1 if the firm is engaged in a merger or acquisition, and 0 otherwise;
BI	percentage of independent directors in the BoD;
CEODUALITY	1 when the CEO also holds the position of the chairman of the board, and 0 otherwise;
BSIZE	number of members in the Board of Directors;
BLOCK	1 if the percentage of shares held by institutional investors are higher than 5 percent, and 0 otherwise;
INV	total inventories on total assets at the end of the year;
REC	total receivables on total assets at the end of the year;
YEAR-DUM	year fixed effect.

Panel B - Fees and Tenure on Audit Quality model

|ABACC|	Absolute value of abnormal accruals;
TENURE	number of years that the auditor has audited the firm's financial statements, since the beginning of the engagement;
SIZE	natural log of total assets at the end of the year;
MB	market to book ratio, equal to market capitalization over shareholders' funds;
ROA	return on assets, equal to EBITDA on total assets at the end of the year
CFO	cash flow from operations scaled by total assets at the beginning of the fiscal year;
LOSS	1 if the firm reports a loss, and 0 otherwise;
LEV	total debt on total assets at the end of the year;
BIG4	1 if the firm is audited by a Big4 firm, and 0 otherwise;
SPEC	1 if the firm is a specialist in the industry, and 0 otherwise;
MERGER	1 if the firm is engaged in a merger or acquisition, and 0 otherwise;
BI	percentage of independent directors;
CEODUALITY	1 when the CEO also holds the position of the chairman of the board, and 0 otherwise;
BSIZE	number of members in the Board of Directors;
BLOCK	1 if the percentage of shares held by institutional investors are higher than 5%;
YEAR-DUM	year fixed effect.

Table 1

Descriptive Statistics for tenure on fee metrics model

	Minimum	Maximum	Mean	Std. Deviation
LOGAF	3,583	9,539	5,829	1,199
LOGTOT	3,651	9,759	6,038	1,250
ABNLAF	-1,674	1,492	0,000	0,571
ABNLTOT	-1,839	1,384	-0,002	0,571
TENURE	1,00	9,00	3,688	2,890
SIZE	8,732	17,424	13,049	1,826
MB	-0,555	13,267	1,250	2,054
ROA	-0,139	0,293	0,079	0,076
CFO	-0,187	0,237	0,057	0,070
LOSS	0,00	1,00	0,209	0,407
LEV	0,00	0,613	0,163	0,148
BIG4	0,00	1,00	0,677	0,467
MERGER	0,00	1,00	0,155	0,362
BI	0,00	88,888	34,090	21,317
CEODUALITY	0,00	1,00	0,219	0,414
BSIZE	5,00	15,00	9,174	2,727
BLOCK	0,00	1,00	0,289	0,453
INV	0,001	0,448	0,135	0,123
REC	0,007	0,553	0,191	0,120

Table 2

Correlation matrix for tenure on fee metrics model

	LOGAF	LOGTOT	ABNLAF	ABNLTOT	TENURE	SIZE	MB	ROA	CFO	LOSS	LEV	BIG4	MERGER	BI	CEO-DUALITY	BSIZE	BLOCK	INV	REC
LOGAF	1																		
LOGTOT	0.9727	1																	
ABNLAF	0.5268	0.4582	1																
ABNLTOT	0.4865	0.5159	0.9034	1															
TENURE	-0.0005	-0.0120	0.1883	0.1663	1														
SIZE	0.8079	0.8199	0.0013	0.0134	-0.1261	1													
MB	0.1205	0.1464	0.1244	0.1530	-0.0123	-0.0012	1												
ROA	0.1493	0.1763	0.0402	0.0446	-0.1225	0.2202	0.3297	1											
CFO	0.1046	0.1280	-0.0184	-0.0202	-0.0473	0.2041	0.2196	0.8421	1										
LOSS	-0.1184	-0.1450	0.0297	0.0221	0.0864	-0.2808	-0.0714	-0.5961	-0.6498	1									
LEV	0.2568	0.2973	-0.0160	-0.0076	-0.0274	0.3722	0.0351	0.0177	0.0048	-0.0638	1								
BIG4	0.2708	0.2931	0.0947	0.1312	-0.0923	0.2477	0.1844	0.0863	0.0639	-0.0469	0.1123	1							
MERGER	0.3113	0.3296	0.0259	0.0207	0.0228	0.2556	0.0398	0.1215	0.1783	-0.1292	0.1133	-0.0287	1						
BI	0.3494	0.3851	0.0339	0.0709	0.0448	0.3960	0.0305	0.0646	0.0326	-0.0967	0.2230	0.1980	0.1595	1					
CEODUALITY	-0.2483	-0.2302	-0.0224	0.0254	0.0064	-0.3095	0.0062	-0.0052	0.0258	0.0378	-0.1171	-0.1153	-0.1223	-0.1833	1				
BSIZE	0.4371	0.4591	-0.0093	0.0117	0.0014	0.5300	-0.0516	0.1409	0.1770	-0.1168	0.3000	0.0986	0.2078	0.2000	-0.2390	1			
BLOCK	0.1704	0.1814	-0.0134	0.0031	-0.1264	0.2634	0.1172	0.1453	0.1210	-0.1520	0.2935	0.1218	0.0323	0.0571	0.0273	0.2207	1		
INV	-0.1593	-0.1715	0.0652	0.0761	-0.0510	-0.2796	0.1490	0.0539	0.0327	-0.0709	-0.2934	-0.0236	-0.1315	-0.2895	0.3405	-0.2152	-0.0431	1	
REC	-0.3871	-0.4079	-0.0261	-0.0590	0.0789	-0.4371	-0.0272	0.0039	-0.0190	0.0623	-0.3538	-0.1973	-0.0976	-0.1500	0.1326	-0.2657	-0.2474	0.2143	1

Table 3
Regression results for tenure on fee metrics model

	logAF	***ABNLAF***	***logTOT***	***ABNLTOT***
intercept	-2,317	-0,648	-2,430	-0,722
	(-4,94)	(-1,45)	(-5,26)	(-1,66)
tenure	0,053***	0,055***	0,044***	0,049***
	(4,14)	(4,25)	(3,23)	(3,68)
size	0,570***	0,012	0,570***	0,004
	(17,59)	(0,38)	(18,15)	(0,12)
roa	1,051	1,544**	1,391*	1,582*
	(1,54)	(2,07)	(1,89)	(1,91)
cfo	-1,936**	-1,604*	-2,221***	-1,839**
	(-2,48)	(-1,97)	(-2,69)	(-2,11)
loss	0,221***	0,031	0,172**	0,005
	(2,96)	(0,45)	(2,24)	(0,07)
lev	-0,541*	-0,160	-0,304	-0,227
	(-1,97)	(-0,60)	(-1,13)	(-0,86)
mb	0,052***	0,021	0,072***	0,029*
	(3,46)	(1,32)	(4,09)	(1,71)
big4	0,212**	0,162**	0,274***	0,218***
	(2,85)	(2,24)	(3,61)	(2,96)
merger	0,293***	0,025	0,322***	0,015
	(4,53)	(0,37)	(4,82)	(0,22)
bi	0,002	0,001	0,005***	0,002
	(1,31)	(0,74)	(2,68)	(1,58)
ceoduality	0,033	-0,019	0,116*	0,059
	(0,60)	(-0,35)	(1,95)	(1,00)
bsize	0,003	-0,003	0,014	0,004
	(0,24)	(-0,26)	(1,04)	(0,35)
block	-0,060	-0,005	-0,099*	-0,007
	(-0,95)	(-0,09)	(-1,56)	(-0,13)
inv	0,272	0,396	0,283	0,457
	(0,96)	(1,44)	(0,91)	(1,54)
rec	-0,652*	-0,356	-0,837**	-0,525
	(-1,97)	(-1,09)	(-2,47)	(-1,55)
Year-dummies	included	included	included	included
Adj. R2	0,74	0,10	0,76	0,11
F-stat	44,76	2,21	59,72	3,13
Prob (F-stat)	< 0,000	< 0,001	< 0,000	< 0,000
N	429	429	429	429

****, **, *** statistically significant at 10%, 5% and 1% , respectively (2-tailed test) – t statistic in parentheses***

FEE represents fee metrics, as previously defined; ABNFEE represent the level of abnormal fee, as previously defined; TENURE is the number of years that the auditor has audited the firm's financial statements since the beginning of the engagement; SIZE is the natural log of total assets at the end of the fiscal year; MB is the market-to-book ratio, equal to market capitalization over shareholders' funds; ROA is the return on assets, equal to ebitda on total assets at the end of the fiscal year; CFO is the cash flow from operations scaled by total assets at the beginning of the fiscal year; LOSS is a dummy variable equal to 1 if the firm reports a loss, and 0 otherwise; LEV is total debts on total assets of the firm at the end of the fiscal year; BIG4 is a dummy variable equal to 1 if the firm is audited by a Big4 firm, and 0 otherwise; MERGER is a dummy variable equal to 1 if the firm is engaged in a merger or acquisition, and 0 otherwise; BI is the percentage of independent directors in the BoD; CEODUALITY is a dummy variable equal to 1 when the CEO also holds the position of the Chairman fo the Board, and 0 otherwise; BSIZE is the number of members in the Board of Directors; BLOCK is a dummy variable equal to 1 if the percentage of shares held by institutional investors are higher than 5 percent, an 0 otherwise; INV is total inventories on total assets at the end of the fiscal year; REC is total receivables on total assets at the end of the fiscal year. We also include YEARdummies as year fixed effect.

Table 4

Descriptive Statistics for tenure on audit quality model

	Minimum	Maximum	Mean	Std. Deviation
ABACC	0,045	0,908	0,411	0,177
TENURE	1,00	9,00	3,682	2,890
SIZE	8,732	17,424	13,049	1,826
MB	-0,555	13,267	1,244	2,059
ROA	-0,139	0,293	0,083	0,076
CFO	-0,187	0,239	0,050	0,060
LOSS	0,00	1,00	0,209	0,407
LEV	0,00	0,622	0,161	0,148
BIG4	0,00	1,00	0,647	0,467
MERGER	0,00	1,00	0,144	0,362
BI	0,00	88,888	33,137	21,377
CEODUALITY	0,00	1,00	0,213	0,424
BSIZE	5,00	15,00	9,198	2,727
BLOCK	0,00	1,00	0,286	0,453

Table 5

Correlation matrix for tenure on audit quality model

	ABACC	TENURE	SIZE	MB	ROA	CFO	LOSS	LEV	BIG4	MERGER	BI	CEODUALITY	BSIZE	BLOCK
ABACC	1													
TENURE	0.0924	1												
SIZE	0.2133	-0.1040	1											
MB	0.0519	-0.0140	0.0100	1										
ROA	0.1453	-0.0888	0.2215	0.3377	1									
CFO	0.2352	-0.0110	0.1865	0.2185	0.8322	1								
LOSS	-0.1420	0.0561	-0.2899	-0.1054	-0.5936	-0.6313	1							
LEV	0.1393	-0.0133	0.3891	0.0507	0.0449	0.0246	-0.0987	1						
BIG4	0.0964	-0.0789	0.2386	0.1898	0.1136	0.0833	-0.0881	0.1328	1					
MERGER	0.0261	0.0246	0.2088	0.0527	0.1023	0.1553	-0.1031	0.1330	-0.0284	1				
BI	0.0052	0.0227	0.4018	0.0342	0.0461	0.0025	-0.0964	0.2162	0.2001	0.1399	1			
CEODUALITY	-0.1158	-0.0191	-0.3298	0.0084	-0.0358	0.0033	0.0520	-0.1361	-0.0979	-0.0843	-0.1695	1		
BSIZE	0.0367	-0.0006	0.5314	-0.0435	0.1521	0.1811	-0.1283	0.3083	0.1269	0.2011	0.2011	-0.2529	1	
BLOCK	0.0162	-0.1351	0.2493	0.1227	0.1373	0.1038	-0.1287	0.2541	0.1295	0.0101	0.0624	0.0359	0.2017	1

Table 6

Regression results for tenure on audit quality model (dependent variable |ABACC||)

intercept	-0,080
	(-0,96)
tenure	0,006**
	(2,01)
size	0,038***
	(6,15)
roa	-0,737***
	(-4,79)
cfo	0,866****
	(4,82)
loss	-0,038**
	(-2,04)
lev	0,087*
	(1,77)
mb	0,008**
	(2,33)
big4	0,003
	(0,12)
merger	-0,015
	(-1,00)
bi	-0,002***
	(-4,73)
ceoduality	-0,005
	(-0,39)
bsize	-0,012***
	(-4,07)
block	-0,032**
	(-2,56)
Year-dummies	included
Adj. R2	0,46
F-stat	17,61
Prob (F-stat)	< 0,000
N	429

****, **, *** statistically significant at 10%, 5% and 1% , respectively (2-tailed test) – t statistic in parentheses***

ABACC is the absolute value of abnormal accruals; TENURE is the number of years that the auditor has audited the firm's financial statements since the beginning of the engagement; SIZE is the natural log of total assets at the end of the fiscal year; MB is the market-to-book ratio, equal to market capitalization over shareholders' funds; ROA is the return on assets, equal to ebitda on total assets at the end of the fiscal year; CFO is the cash flow from operations scaled by total assets at the beginning of the fiscal year; LOSS is a dummy variable equal to 1 if the firm reports a loss, and 0 otherwise; LEV is total debts on total assets of the firm at the end of the fiscal year; BIG4 is a dummy variable equal to 1 if the firm is audited by a Big4 firm, and 0 otherwise; MERGER is a dummy variable equal to 1 if the firm is engaged in a merger or acquisition, and 0 otherwise; BI is the percentage of independent directors in the BoD; CEODUALITY is a dummy variable equal to 1 when the CEO also holds the position of the Chairman of the Board, and 0 otherwise; BSIZE is the number of members in the Board of Directors; BLOCK is a dummy variable equal to 1 if the percentage of shares held by institutional investors are higher than 5 percent, an 0 otherwise; YEARdummies represent the year fixed effect.

Table 7

Regression results for the first period of tenure on audit quality model (dependent variable |ABACC|)

intercept	-0,056
	(-0,66)
first_tenure	-0,037***
	(-2,71)
size	0,038***
	(6,18)
roa	-0,733***
	(-4,79)
cfo	0,864***
	(4,83)
loss	-0,037**
	(-2,03)
lev	0,088*
	(1,79)
mb	0,008**
	(2,30)
big4	0,005
	(0,22)
merger	-0,013
	(-0,91)
bi	-0,002***
	(-4,67)
ceoduality	-0,006
	(-0,41)
bsize	-0,012***
	(-4,13)
block	-0,032***
	(-2,55)
Year-dummies	included
Adj. R2	0,46
F-stat	17,32
Prob (F-stat)	< 0,000
N	429

****, **, *** statistically significant at 10%, 5% and 1% , respectively (2-tailed test) – t statistic in parentheses***

ABACC is the absolute value of abnormal accruals; FIRST_TENURE represents the period of the first three years of auditor engagement; SIZE is the natural log of total assets at the end of the fiscal year; MB is the market-to-book ratio, equal to market capitalization over shareholders' funds; ROA is the return on assets, equal to ebitda on total assets at the end of the fiscal year; CFO is the cash flow from operations scaled by total assets at the beginning of the fiscal year; LOSS is a dummy variable equal to 1 if the firm reports a loss, and 0 otherwise; LEV is total debts on total assets of the firm at the end of the fiscal year; BIG4 is a dummy variable equal to 1 if the firm is audited by a Big4 firm, and 0 otherwise; MERGER is a dummy variable equal to 1 if the firm is engaged in a merger or acquisition, and 0 otherwise; BI is the percentage of independent directors in the BoD; CEODUALITY is a dummy variable equal to 1 when the CEO also holds the position of the Chairman fo the Board, and 0 otherwise; BSIZE is the number of members in the Board of Directors; BLOCK is a dummy variable equal to 1 if the percentage of shares held by institutional investors are higher than 5 percent, an 0 otherwise; YEARdummies represent the year fixed effect.

Table 8
Regression results for the last period of tenure on audit quality model (dependent variable |ABACC|)

intercept	-0,043
	(-0,51)
last_tenure	0,004
	(0,25)
size	0,037***
	(5,92)
roa	-0,771***
	(-5,00)
cfo	0,902***
	(5,00)
loss	-0,037**
	(-2,01)
lev	0,090*
	(1,82)
mb	0,008**
	(2,45)
big4	0,001
	(0,03)
merger	-0,015
	(-1,00)
bi	-0,002***
	(-4,62)
ceoduality	-0,006
	(-0,43)
bsize	-0,012***
	(-3,95)
block	-0,035***
	(-2,74)
Year-dummies	included
Adj. R2	0,45
F-stat	16,88
Prob (F-stat)	< 0,000
N	429

****, **, *** statistically significant at 10%, 5% and 1% , respectively (2-tailed test) – t statistic in parentheses***

ABACC is the absolute value of abnormal accruals; LAST_TENURE represents the period of the last three years of auditor engagement; SIZE is the natural log of total assets at the end of the fiscal year; MB is the market-to-book ratio, equal to market capitalization over shareholders' funds; ROA is the return on assets, equal to ebitda on total assets at the end of the fiscal year; CFO is the cash flow from operations scaled by total assets at the beginning of the fiscal year; LOSS is a dummy variable equal to 1 if the firm reports a loss, and 0 otherwise; LEV is total debts on total assets of the firm at the end of the fiscal year; BIG4 is a dummy variable equal to 1 if the firm is audited by a Big4 firm, and 0 otherwise; MERGER is a dummy variable equal to 1 if the firm is engaged in a merger or acquisition, and 0 otherwise; BI is the percentage of independent directors in the BoD; CEODUALITY is a dummy variable equal to 1 when the CEO also holds the position of the Chairman fo the Board, and 0 otherwise; BSIZE is the number of members in the Board of Directors; BLOCK is a dummy variable equal to 1 if the percentage of shares held by institutional investors are higher than 5 percent, an 0 otherwise; YEARdummies represent the year fixed effect.

Table 9
Regression results for TEN1 and TEN9 on audit quality model
(dependent variable |ABACC|)

intercept	-0,046	-0,043
	(-0,55)	(-0,51)
ten1	-0.041**	
	(-2,06)	
ten9		-0,012
		(-0,32)
size	0,037***	0,037***
	(6,09)	(5,90)
roa	-0,784***	-0,786***
	(-5,18)	(-5,02)
cfo	0,886***	0,914***
	(4,99)	(5,07)
loss	-0,039**	-0,038**
	(-2,11)	(-2,04)
lev	0,083*	0,090*
	(1,69)	(1,82)
mb	0,008**	0,008**
	(2,39)	(2,47)
big4	0,001	0,000
	(0,04)	(0,02)
merger	-0,015	-0,014
	(-1,03)	(-0,97)
bi	-0,002***	-0,002***
	(-4,62)	(-4,63)
ceoduality	-0,007	-0,006
	(-0,49)	(-0,45)
bsize	-0,011***	-0,011***
	(-3,99)	(-3,95)
block	-0,033***	-0,035***
	(-2,66)	(-2,78)
Year-dummies	included	included
Adj. R2	0,46	0,45
F-stat	17,48	16,74
Prob (F-stat)	< 0,000	< 0,000
N	429	429

****, **, *** statistically significant at 10%, 5% and 1% , respectively (2-tailed test) – t statistic in parentheses***

ABACC is the absolute value of abnormal accruals; TEN1 is the first year of auditor engagement after MAR; TEN9 is the last year of auditor engagement, before the MAR; SIZE is the natural log of total assets at the end of the fiscal year; MB is the market-to-book ratio, equal to market capitalization over shareholders' funds; ROA is the return on assets, equal to ebitda on total assets at the end of the fiscal year; CFO is the cash flow from operations scaled by total assets at the beginning of the fiscal year; LOSS is a dummy variable equal to 1 if the firm reports a loss, and 0 otherwise; LEV is total debts on total assets of the firm at the end of the fiscal year; BIG4 is a dummy variable equal to 1 if the firm is audited by a Big4 firm, and 0 otherwise; MERGER is a dummy variable equal to 1 if the firm is engaged in a merger or acquisition, and 0 otherwise; BI is the percentage of independent directors in the BoD; CEODUALITY is a dummy variable equal to 1 when the CEO also holds the position of the Chairman fo the Board, and 0 otherwise; BSIZE is the number of members in the Board of Directors; BLOCK is a dummy variable equal to 1 if the percentage of shares held by institutional investors are higher than 5 percent, an 0 otherwise; YEARdummies represent the year fixed effect.

Table 10
Regression results for TEN12, TEN45 and TEN89 on audit quality model (dependent variable |ABACC|)

intercept	-0,056	-0,082	-0,043
	(-0,67)	(-0,94)	(-0,51)
ten12	-0,036**		
	(-2,30)		
ten45		0,031**	
		(2,31)	
ten89			-0,009
			(-0,42)
size	0,038***	0,038***	0,036***
	(6,15)	(6,03)	(5,90)
roa	-0,773***	-0,791***	-0,792***
	(-5,11)	(-5,16)	(-4,99)
cfo	0,884***	0,915***	0,920***
	(4,97)	(5,13)	(5,01)
loss	-0,040**	-0,037**	-0,037**
	(-2,15)	(-1,99)	(-2,02)
lev	0,083*	0,089*	0,090*
	(1,68)	(1,81)	(1,82)
mb	0,008**	0,008**	0,008**
	(2,38)	(2,39)	(2,48)
big4	0,004	0,003	0,001
	(0,17)	(0,13)	(0,03)
merger	-0,014	-0,012	-0,014
	(-0,98)	(-0,79)	(-0,96)
bi	-0,002***	-0,002***	-0,002***
	(-4,66)	(-4,44)	(-4,62)
ceoduality	-0,006	-0,006	-0,006
	(-0,48)	(-0,48)	(-0,45)
bsize	-0,011***	-0,012***	-0,011***
	(-4,00)	(-4,06)	(-3,94)
block	-0,034***	-0,035***	-0,036***
	(-2,67)	(-2,80)	(-2,82)
Year-dummies	included	included	included
Adj. R2	0,46	0,46	0,45
F-stat	17,13	16,65	16,63
Prob (F-stat)	< 0,000	< 0,000	< 0,000
N	429	429	429

****, **, *** statistically significant at 10%, 5% and 1% , respectively (2-tailed test) – t statistic in parentheses***

ABACC is the absolute value of abnormal accruals; TEN12 represents the first two years of auditor engagement after MAR; TEN45 represents the fourth and fifth year of the auditor engagement; TEN89 represents the last two years of auditor engagement, before the MAR; SIZE is the natural log of total assets at the end of the fiscal year; MB is the market-to-book ratio, equal to market capitalization over shareholders' funds; ROA is the return on assets, equal to ebitda on total assets at the end of the fiscal year; CFO is the cash flow from operations scaled by total assets at the beginning of the fiscal year; LOSS is a dummy variable equal to 1 if the firm reports a loss, and 0 otherwise; LEV is total debts on total assets of the firm at the end of the fiscal year; BIG4 is a dummy variable equal to 1 if the firm is audited by a Big4 firm, and 0 otherwise; MERGER is a dummy variable equal to 1 if the firm is engaged in a merger or acquisition, and 0 otherwise; BI is the percentage of independent directors in the BoD; CEODUALITY is a dummy variable equal to 1 when the CEO also holds the position of the Chairman fo the Board, and 0 otherwise; BSIZE is the number of members in the Board of Directors; BLOCK is a dummy variable equal to 1 if the percentage of shares held by institutional investors are higher than 5 percent, an 0 otherwise; YEARdummies represent the year fixed effect.

Chapter 3

Partner seniority and its effects on audit job: the impact of cultural aspects in the Italian context

Abstract

The partner's role in audit firms and his relationship with clients is an increasingly studied topic in auditing research. The aim of the study is to examine the effects of partner behaviours on audit job, when partner seniority increases. Moreover, we explore the impact of some peculiar cultural characteristics that epitomize the Italian context, such as the power distance and the gerontocracy, have on individual behaviours.

Using a sample of Italian listed firms, we find a significant positive association between partner seniority and abnormal level of fees, both for audit and total fees. Basing on the assumptions of the paper, it indicates an increasing interest of partner in the growth of profits and power, when seniority increases.

However, this growth is not justified by an increasing audit quality. Indeed, the second analysis shows there is no effect of partner seniority on audit quality, measured by abnormal accruals. The study develop the research on audit job, with an innovative way to analyse the partner's role.

Keywords: partner seniority, power distance, gerontocracy, abnormal fees, audit quality, abnormal accruals

1. Introduction

The audit partner's role and his influence in the relationship with firm's management is a topic increasingly studied by auditing scholars in the last years (Bell et al., 2015; Goodwin & Wu, 2014). Accordingly, a number of scholars have gradually examined several features of the audit partner, which in turn result of critical importance for the audit firm's management. For instance, some scholars have analysed the role of auditor tenure (Hamilton et al., 2005; Chi et al., 2009; Daugherty et al., 2012; Litt et al., 2014). Others, instead, have focused on auditor expertise (Carcello and Nagy, 2004; Liu and Simunic, 2005; Zerni, 2012; Goodwin and Wu, 2014). Taken together, extant research highlights that the audit partner plays an important role in the audit firm because of its influence on audit job. In the attempt to join this academic conversation, we try to provide a better understanding of audit partner's behaviours. Specifically, the aim of the study is to examine the influence of partner behaviours on audit job, when partner seniority increases. Additionally, we address this research question in the Italian context, where some peculiar cultural characteristics, such as the power distance and the gerontocracy, have a strong impact on individual behaviours, for both private and professional ones.

Accordingly, both organizations' strategies and performances are often linked to the pressures employed by the institutional context on human behaviours (Powell and DiMaggio, 1983;_1991). Moreover, several previous studies provided evidence on the importance of national culture, for its strong impact on leadership styles and individual practices and, consequently, on economic results (Dickson et al., 2003; Tsui et al., 2007). Also in the audit research, there are studies suggesting that partner behaviour and his involvement in audit activity can vary by national culture; they examine the dimensions identifying and standing

out the role, the position and the relationships of an auditor, such as power distance, individualism versus collectivism, and uncertainty avoidance (Bik and Hooghiemstra, 2017).

The Italian context presents some dimensions analysed by previous studies. Specifically, an important and prevalent characteristic that epitomizes the Italian context relates to the power distance. Power distance is related to the degree of centralization of authority and the degree of autocratic leadership (Hofstede, 1983; p.81) and it indicates the distance between two members of a firm in different positions: one in a leading position and another one in minor position. In countries with high power distance, leaders are less likely to share decision-making power, while other people are willing to accept hierarchy (Cohen et al., 1993).

Hofstede (1983)'s study, that is the first one to identify this aspect, has shown that Italy is a country with high level of power distance. In this situation, a leader is willing to protect his power by creating barriers that impede other people of the firm to develop their skills and to achieve leading positions.

Consequently, the search of individual power and the successive maintenance of power distance constitute the fertile ground for the relevance of another important and pervasive characteristic of the Italian context: the gerontocracy. Accordingly, some studies (see, among others, Catani, 2014), are focused on the difficult and slow generational change that characterize leading positions in the Italian context. Indeed, these studies argue that a leader with strong "attachment to the seat of power" affects the generational change in the firm. In fact, his intentions to keep the power for a longer possible period prevent other people to take part in the decision maker process of the firm. As a result, it is not a surprise that the firm's decision-making power resides in the hands of older and more experienced people.

In the audit market, this means that a partner is old and he probably has the maximum level of competence and experience. Moreover, he maintains a power distance with people in minor positions and tries to improve his power in the market.

In this phase, the procedures he uses to improve and maintain his power over time are very important, such as the close relationships with the team and, in particular, with the clients. These close relationships, indeed, allow him to improve and to fortify his reputation in the market; moreover, he can grab the biggest and profitable clients. On the other hand, audited firms are more likely to pay higher audit fees to a powerful partner, because they retain him an assurance of reliability for the external market.

In line with this reasoning, in this study we argue that when the seniority increases, the characteristics explained above could emphasize. Consequently, we decide to analyse the impact of partner behaviour on the audit job, using, on one hand, the partner seniority and, on the other hand, the two most considered aspects of the audit job in audit research, i.e., audit fees and audit quality.

We perform a statistical analysis of Italian listed firms, in the period 2010-2013; we firstly provide evidence on the relation between partner seniority and abnormal audit fees, measured by Blankley et al (2012)'s model. Then, we relate the same measure of seniority with audit quality, measured as abnormal accruals.

The results of the first analysis demonstrate a significant and positive relation between partner seniority and abnormal fees. According to our assumptions, these results show an increasing attention of partner to improve his profits, often exceeding the normal level of fees; therefore, high partner seniority leads to high audit costs for clients. This situation may be justified if it consequently leads to an improvement of audit quality. However, with the second analysis, we show there is not a significant association between partner seniority and audit quality in the Italian context.

Drawing on the results of the two analyses and considering the cultural characteristics explained above, we argue that an older partner aims to maintain a power distance as well as to accrue this power to gain the right to additional profits. In addition, we claim that an older partner devotes less time and diligence for audit activity (Sundgren and Svanstrom, 2014). Furthermore, when his skills and experience are at a maximum level, the seniority fall short to augment his job and consequently his audit quality. This, in turn, implicates the absence of significant audit quality improvement when partner seniority increases.

Basing on these findings, this study offers some contributions to the audit literature on the partner's role. First, this study enriches extant literature on audit partner, by showing that cultural and institutional characteristics of the context analysed have an impact on partner behaviours. In particular, this study shows that partner supremacy and partner power have an influence on partner behaviours. This result, in turn, may allow to develop a new research field on the topic of partner role.

Second, we believe that the study poses an intriguing question on the efficacy of partner rotation in Italy. In fact, this study shows that when a partner taking the engagement is old and powerful, nominating a new partner during the engagement does not have a positive impact on auditor independence; this because, although the new partner carries out the daily audit activity, the real decision-making power resides in the hands of the older and powerful partner.

Last but not least, the study may give useful insights for regulators and control bodies (in the case of Italian context it is the Consob). As example, it could be convenient to develop a specific task for the control of the assignment of audit firm and auditor to an engagement, reducing the freedom of partner and audit firms; today, in fact, it depends on a free negotiation between the parts.

The remainder of the study is organized as follows. In section 2 we provide an institutional background and develop the hypotheses; in section 3 we discuss the research design and the main variables' measurement; in section 4 we report and describe the results of the analyses; in section 5 we present conclusions, limitations and opportunities for future research.

2. Institutional background and hypotheses development

In the contractual phase with audit client and the administration of audit engagement, partner has a leading role and he is a fundamental decision-maker, more than the audit firm or the office in which he performs his tasks. In particular, in contexts in which partner signature is required, as the Italian one, partner is directly responsible for final audit report that he signs.

Consequently, individual characteristics of the partner are important for the development of audit activity, such as the experience, the skills, and the seniority. Partner's behaviours and objectives can positively or negatively diverge over time. For these reasons, we decide to analyse partner behaviours and how these behaviours change when partner seniority increases.

In order to achieve our aim, we believe it is necessary to consider all the peculiar cultural and institutional characteristics of the context in which the partner performs his tasks.

Individual behaviours and outcomes are strongly influenced by national culture and its traditions (Powell and DiMaggio, 1983); people cannot alter their ethnicity, race or family history and they transpose them in their daily behaviours and preferences, in the private life

as in the professional one (Becker et al., 1996). Often differences in national cultures can describe the resources used by managers in professional behaviours (Smith et al., 2002).

In auditing research, several studies have analysed the impact of cultural aspects on audit firms and their partner. BiK and Hooghiemstra (2017), for example, emphasized the importance of cultural aspects on partner behaviour in audit job. The authors argue that some cultural dimensions such as power distance, individualism versus collectivism and uncertainty avoidance have a strong impact on partner involvement and his performance. Accordingly, Patel et al. (2002) use the same dimensions to show cultural differences among Chinese, Australian and Indian contexts, and their effects on professional partner behaviours.

According to our considerations, we provide evidence on the impact of partner seniority on auditor job, through its relation with the most analysed audit aspects; i.e., 1) audit fees 2) audit quality. Furthermore, we consider the prevalent individual characteristics of Italian partner, such as the power distance and, consequently, the gerontocracy. Indeed, we find that among cultural characteristics that have impact on individual professional outcomes in the context we analyse, these are the most representative of the Italian context (Catani, 2014; Hofstede, 1983).

The power distance and the gerontocracy are both peculiar aspects that epitomize the Italian context. At the same time, they are strictly linked in a cause-effect relationship; sometimes one is a consequence of another one. An individual who covers a leading position and maintains a power distance, tries to hinder other people to achieve his position. In particular, he tries to improve his power in the audit environment and to exhibit it, avoiding someone can reach or, even, pass him. This situation implicates that a person in minor position will be able to achieve the leading position when he is old and, in particular, his skills and experiences are already high; therefore, it is unlikely that can acquire other relevant competence on the audit job while working as a partner.

Hence, from the achievement of the leading position to the growth of his seniority and his relationship with clients and other auditors, partner behaviour and objectives may change.

As described above, we believe that partner attitudes are increasingly oriented to profits and power while less oriented to the individual professional growth and the quality of audit job over time.

In the sub-sections that follow, we develop the topic of partner seniority and its impact on audit job in Italy.

2.1. Seniority and fees

As explained above, and basing on cultural aspects that distinguish the Italian context with respect to other ones, partner who achieve the leading position creates a distance towards people working for him, focusing the attention to search power and to create strong relationships with other people, especially his clients (Nolder and Riley, 2014). When partner achieves these objectives, he can grab big and profitable clients more easily (Stewart et al., 2016). Moreover, the increasing profits can exceed the so-called normal level of fees.

On the other hand, clients can be willing to pay higher fees when they recognize high market power in their partner; they, in fact, believe that a powerful partner can assure higher reliability towards the market and institutional investors.

Drawing on these considerations, we expect that an increasing partner seniority leads to an increase in the audit fees, that exceed the normal level. For this reason, we do not consider the general audit fees, but a measure of abnormal fees. In our opinion, they may capture the economic relationship between partner and client better. Therefore, we forge the following hypothesis:

***H_1**: a growth of partner seniority is associated with higher abnormal fees.*

2.2. Seniority and quality

Studies on the association between audit quality and partner expertise indicate an improvement of quality when partner has more experience and competence. Indeed, the assumptions on the improvement of audit quality are based on the higher possibility for expert partner in deterring financial fraud, or in the mitigation of accrual-based earnings management (Krishnan, 2003; Liu and Simunic, 2005).

Consequently, these studies argue that a high partner expertise leads to an improvement of audit quality, also justifying the higher fees paid by clients (Carcello and Nagy, 2004; Zerni, 2012).

However, we assume that an increasing partner seniority does not have a linear relation with an increasing expertise and, therefore, with the audit quality. Specifically, we claim that a partner obtains the leading position after many years, when he is old, very expert and less interested in acquiring other competence. Therefore, the growth of partner seniority should involve a limited marginal growth of skills and, consequently, of the audit quality.

Moreover, according to the theory of power distance, when he achieves the position, he centralizes in his hands all the power related to the engagement, to both clients and the team, with which he has an adequate level of power distance. This leads to a slow generational change.

Giving the first hypothesis, we assume that the positive relation between partner seniority and abnormal fees is not justified by an improvement of audit quality.

Therefore, we advance the following hypothesis:

***H_2**: when partner seniority increases, audit quality does not increase.*

3. Research design

3.1. Sample selection

In order to test our hypotheses, we perform statistical analyses on a panel dataset. In particular, we select firms listed on Milan Stock Exchange, over a period of four years (2010-2013). We exclude firms from financial sector for their different accounting practices and unique fee determinants (Taylor, 2011; Carson et al., 2012). Financial data are extracted from the Amadeus and Compustat database. Moreover, data on audit fees, audit tenure and corporate governance are hand collected, by extracting these information from each firm's financial and corporate governance reports.

Our initial sample consists of 920 observations. Then, we delete some observations because of unavailability of data. The final sample consists of 412 observations for the first analysis and 416 for the second one.

3.2. Variables' measurement

We test our hypotheses using two models with two different dependent variables. These variables, in turn, are estimated through the following regression models, that we present below.

3.2.1. Abnormal fees

Abnormal fees are defined as the difference between the audit fee paid and the expected audit fee. According to previous literature, abnormal fees indicate the level of the economic relationship between the auditor and his client, that could decrease the auditor independence (Blankley et al., 2012). Moreover, while normal fees are determined by factors commonly different among firms, such as firm size, complexity and risk, abnormal fees are, instead, determined by factors specific to the auditor-client relationship. These factors can capture

economic rents associated with audit services performed better than normal fees (Knechel et al., 2013; Hribar et al., 2014).

We decide to measure abnormal audit fee applying the model from Blankley et al., (2012)'s study, which is, to the best of our knowledge, the most used model by previous literature. This model regresses logged audit fees on variables representing clients' characteristics, specifically controlling for risk, audit effort and industry.

However, because of unavailability of data, we exclude a variable from the original model, used as a proxy for internal control problem of firms. In particular, we refer to the presence of a material weakness in the current year or the subsequent year (MATWEAK). Therefore, abnormal fees, at year *t*, are measured as follows:

$$LAF = \alpha_0 + \alpha_1 LTA + \alpha_2 CR + \alpha_3 CA\_TA + \alpha_4 ARINV + \alpha_5 ROA + \alpha_6 LOSS + \alpha_7 FOREIGN + \alpha_8 MERGER + \alpha_9 BUSY + \alpha_{10} LEV + \alpha_{11} INTANG + \alpha_{12} SEG + \alpha_{13} OPINION + \alpha_{14} INDUSTRY + \varepsilon \quad \textbf{[1]}$$

where:

LAF= logarithm of fees (audit or total);

LTA= logarithm of end of year total assets;

CR= current assets divided by current liabilities;

CA_TA= current assets divided by total assets;

ARINV= sum of accounts receivable and inventory divided by total assets;

ROA= earnings before interest and taxes divided by total assets;

LOSS= 1 if the firm incurred a loss, 0 otherwise;

FOREIGN= 1 if the firm has any foreign operations, 0 otherwise;

MERGER= 1 if the firm reported the impact of a merger or acquisition on net income, 0

otherwise;

BUSY= 1 if the firm's fiscal year is December 31st, 0 otherwise;

LEV= long-term debt divided by total assets;

INTANG= ratio of intangible assets to total assets;

SEG= logarithm of number of business segments;

OPINION= 1 if the auditor issues a going concern audit opinion, 0 otherwise;

INDCOM= industry fixed effects.

Abnormal fees are calculated as the signed residual of this model. In particular, we use this model to obtain two measures of abnormal fees: the first one by using data of only audit fees (ABNLAF), and the second one by utilizing data of total fees, composed by audit and non-audit fees (ABNLTOT). These two measures are used as dependent variables for the model testing the first hypothesis.

3.2.2. Abnormal accruals

Abnormal accruals are commonly used as proxy for earnings management and, consequently, as measure of audit quality. Although other proxies are also used to measure audit quality, most of them are unavailable in the Italian context.

We decide to use unsigned discretionary accruals to capture the quality of an audit. Following prior studies, we use the cross-sectional modified-Jones model (Dechow, 1995) to measure abnormal accruals.

Therefore, for each one-digit SIC code, we estimate the following model:

$$TA_t/A_{t-1} = \alpha\ 1/A_{t-1} + \beta_1\ (\Delta REV - \Delta REC)/A_{t-1} + \beta_2\ PPE/A_{t-1} + \varepsilon \qquad \textbf{\textit{[2]}}$$

where

TA_t = Total accruals, defined as the difference between earnings and cash flow from operations.

ΔREV = Change in total revenues, between the fiscal year and the previous year.

ΔREC = Change in accounts receivable, between the fiscal year and the previous year.

PPE = Total property, plant and equipment at the end of the fiscal year.

A_{t-1} = Total assets at the beginning of the fiscal year.

Discretionary accruals are measured as absolute value of the residual from the above model.

In order to improve the specification and the power of the model, we adjust for firm performance, as suggested by Kothari *et al.* (2005). In fact, these authors advocate that non-discretionary accruals are highly correlated with current firm performance.

The above estimation of abnormal accruals is used as dependent variable for testing the second hypothesis of our study.

3.3. Models' specification

After providing a detailed explanation of the dependent variables we use in our analyses, we present the two models used to test our hypotheses. The structure of the models used in this study follows previous literature on audit fees and audit quality. In particular, the model 1 analyses the association between partner seniority (PTSEN), as independent variable, and the two measures of abnormal fees (ABNLAF, ABNLTOT), as dependent ones.

The model 1 is explained as follows:

$$ABNFEE = \alpha_0 + \alpha_1 PTSEN + \alpha_2 FTEN + \alpha_3 PTTEN + \alpha_4 SIZE + \alpha_5 MB + \alpha_6 ROA + \alpha_7 CFO + \alpha_8 LEV + \alpha_9 LOSS + \alpha_{10} BIG4 + \alpha_{11} MERGER + \alpha_{12} BSIZE + \alpha_{13} BI + \alpha_{14} CEODUALITY + \alpha_{15} BLOCK + \alpha_{16} INV + \alpha_{17} REC + \alpha_{18} YDUM + \varepsilon$$

[3]

We control for variable firm size (SIZE), market-to-book ratio (MB), return-on-assets (ROA), operating cash flows (CFO), leverage (LEV) and lagged loss (LOSS), merger and acquisitions (MERGER), inventories (INV) and receivables (REC). Moreover, we include audit firm size (BIG4), the length of audit tenure (FTEN) and some variables controlling for corporate governance (BSIZE, BI, CEODUALITY, BLOCK). The variables' explanation are reported in the appendix (Appendix A, panel A).

Further, we adopt the same independent variable (PTSEN), examining its association with audit quality, measured by abnormal accruals (ABACC).

The model 2 is explained as follows (Appendix A, panel B):

$$|ABACC| = \alpha_0 + \alpha_1 PTSEN + \alpha_2 FTEN + \alpha_3 PTTEN + \alpha_4 SIZE + \alpha_5 MB + \alpha_6 ROA + \alpha_7 CFO + \alpha_8 LEV + \alpha_9 LOSS + \alpha_{10} BIG4 + \alpha_{11} MERGER + \alpha_{12} BSIZE + \alpha_{13} BI + \alpha_{14} CEODUALITY + \alpha_{15} BLOCK + \alpha_{16} YEARDUM + \varepsilon$$

[4]

Also in this case, we control for variables usually included by previous studies (Cameran et al., 2015; Lennox et al., 2014), such as firm size (SIZE), market-to-book ratio (MB), return-on-assets (ROA), operating cash flows (CFO), leverage (LEV), prior-year loss

(LOSS), merger and acquisitions (MERGER), with some variables for audit firm (BIG4 and FTEN) and others for firm's corporate governance (BSIZE, BI, CEODUALITY, BLOCK).

In the next section of the study, we present the results of the analyses.

4. Results

4.1. Seniority-fees model

The table 1 reports the descriptive statistics of variables used in the first model.

(Insert Table 1 about here)

The mean of abnormal audit and total fees are, respectively, 0.000 and -0.002. The mean firm tenure is 3.688 while partner tenure amounts to 3.008. Moreover, the descriptive statistic shows that in Italy the main part of firms (around 67%) are audited by Big4 audit firms (KPMG, Ernst and Young, PriceWaterhouseCoopers, Deloitte & Touche). The values are similar to other studies in similar countries.

Moreover, table 2 shows the correlation matrix.

(Insert Table 2 about here)

As Table 2 shows, there are no multicollinearity problems in our analysis.

The results of the regression analysis on the effect that partner seniority has on abnormal fees are shown in Table 3.

(Insert Table 3 about here)

In particular, the first part of Table 3 presents the results of the association between partner seniority and the abnormal level of only audit fees. The model is very significant (F< 0.000) and the adjusted R^2 is high (0.85). Therefore, it proves highly significance and demonstrates a very good fit in explaining the association investigated. As expected, the results provide evidence of a significant and positive relation between partner seniority (PTSEN) and abnormal audit fees ($p<0.05$). This suggests that as the seniority increases, a partner is more likely to augment the level of audit fees to his clients.

The results of the same analysis with the abnormal total fees, which includes audit and non-audit services in it, are very similar. Also in this case, the results indicate a high Adjusted R^2 (0.73) and F value significant at 0.000 level. Moreover, it provides evidence of a significant and positive relation between partner seniority and abnormal total fees. The results are consistent with H_1.

Furthermore, the main part of the control variables are significant, as proof of robustness of the test. As example, the results demonstrate a strong influence of firm tenure on the growth of fees ($p<0.01$). Finally, the analysis shows that increasing abnormal fees, in particular as those regarding audit fees, are strongly and positively influenced for firms audited by a Big4 audit firm.

4.2. Seniority-quality model

The Table 4 reports the descriptive statistics of variables used in the second model.

(Insert Table 4 about here)

Because we consider the same sample of firms we have used in the first model, with the only exception that we include four additional firms, the values that are presented in Table 4 are similar to the ones we showed previously with regards to the first model.

Moreover, Table 5 shows the correlation matrix.

(Insert Table 5 about here)

Also in this case, the Table 5 does not present multicollinearity problems.

Table 6 reports the regression results on the association between partner seniority and audit quality.

(Insert Table 6 about here)

It reports an Adjusted R^2 not very high (0.16), but consistent with studies on the Italian context and F value at 0.000 level. Consistently with the assumption of H_2, these findings demonstrate that there is not a significant association between the two variables (ABACC-PTSEN) ($p>0.010$). Therefore, a senior partner does not have a significant influence on the improvement of the audit quality. Differently from the first analysis, also the main part of control variable is not significant.

Hence, we suggest that high costs for an audit paid by clients to a senior partner are not justified by an improvement of quality of audit job.

5. Conclusions

The purpose of the study is to analyse partner behaviours and how these behaviours influence audit job, when partner seniority increases. In order to address this question, we have examined the impact that some peculiar characteristics of the Italian context have on individual behaviour.

While previous scholars on the audit research have analysed the impact of national culture on individual professional outcomes (Bik and Hooghiemstra, 2017; House et al., 2004; Tsui et al. 2007), in this study we identify two important characteristics that epitomize the Italian context: a) the power distance, b) the gerontocracy. In particular, we investigated how these two characteristics distinguish partner behaviours when partner seniority increases and how, consequently, this relation could have effect on auditor job.

The analysis on a sample of Italian listed firms shows that, when partner seniority increases, a partner focuses the attention on his power and profits; in fact, the analysis on partner seniority and abnormal fees shows a positive and significant relation between the two aspects. Moreover, the second analysis shows that this growth of fees cannot be justified by an improvement of the audit quality, because there is not a significant relation between partner seniority and audit quality.

The results of our analysis can have important implications for regulators, auditors and firms and they can contribute to the development of future research. In fact, cultural aspects of the Italian context and their influence on partner behaviour introduce a new perspective in the academic research.

Moreover, this study can also be useful to the development of legislative framework of auditing in Italy, in particular as regards the efficiency of partner rotation. In fact, it is possible that the appointment of a new partner during the audit engagement cannot improve

the auditor independence, because the real decision-making power is always in the hands of the first and more powerful partner, who probably has also a closer relationship with the client.

Finally, a suggestion from this study regards a growth of tasks of the external entities, such as Consob in Italy, that controls audit firms, partner and their independence. It is possible to provide for a stronger control of the independent institution on the assignment of audit firm and partner to clients. In this case, they could avoid that free negotiations lead to an uncontrolled individual power of partner.

Future studies may enhance this intriguing topic, also developing new aspects on partner role and his behaviour.

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APPENDIX A: variable definitions

Panel A – partner seniority /abnormal fee model

ABNFEE	The abnormal value of fees, defined as follows: - ABNLAF is the abnormal value of audit fees; - ABNLTOT is the abnormal value of total fees, including audit and non-audit services;
PTSEN	number of years that the auditor is partner in the audit firm;
FTEN	number of years that the audit firm has audited the firm's financial reports, since the beginning of the engagement;
PTTEN	number of years that the partner has audited the firm's financial reports
SIZE	natural log of total assets at the end of the fiscal year;
MB	market to book ratio, equal to market capitalization over shareholders' funds;
ROA	return on assets, equal to EBITDA on total assets at the end of the year;
CFO	cash flow from operations scaled by total assets at the beginning of the fiscal year;
LEV	total debt on total assets at the end of the fiscal year;
LOSS	1 if the firm reports a loss, and 0 otherwise;
BIG4	1 if the firm is audited by a Big4 firm, and 0 otherwise;
MERGER	1 if the firm is engaged in a merger or acquisition, and 0 otherwise;
BSIZE	number of members in the Board of Directors;
BI	percentage of independent directors in the BoD;
CEODUALITY	1 when the CEO also holds the position of the chairman of the board, and 0 otherwise;
BLOCK	1 if the percentage of shares held by institutional investors are higher than 5 percent, and 0 otherwise;
INV	total inventories on total assets at the end of the year;
REC	total receivables on total assets at the end of the year;
YEAR-DUM	year fixed effect.

Appendix A

Panel B – partner seniority/ audit quality model

|ABACC|	Absolute value of abnormal accruals;
PTSEN	number of years that the auditor is partner in the audit firm;
FTEN	number of years that the auditor has audited the firm's financial statements, since the beginning of the engagement;
PTTEN	number of years that the partner has audited the firm's financial reports
SIZE	natural log of total assets at the end of the year;
MB	market to book ratio, equal to market capitalization over shareholders' funds;
ROA	return on assets, equal to EBITDA on total assets at the end of the year
CFO	cash flow from operations scaled by total assets at the beginning of the fiscal year;
LEV	total debt on total assets at the end of the year;
LOSS	1 if the firm reports a loss, and 0 otherwise;
BIG4	1 if the firm is audited by a Big4 firm, and 0 otherwise;
MERGER	1 if the firm is engaged in a merger or acquisition, and 0 otherwise;
BSIZE	number of members in the Board of Directors;
BI	percentage of independent directors;
CEODUALITY	1 when the CEO also holds the position of the chairman of the board, and 0 otherwise;
BLOCK	1 if the percentage of shares held by institutional investors are higher than 5%;
YEAR-DUM	year fixed effect.

Table 1

Descriptive Statistics for partner seniority on abnormal fees

	Minimum	Maximum	Mean	Std. Deviation
ABNLAF	-1,674	1,492	0,000	0,562
ABNLTOT	-1,839	1,385	-0,001	0,571
PTSEN	1	39	14,666	8,037
FTEN	1	9	3,688	2,890
PTTEN	1	7	3,008	2,013
SIZE	8,732	17,424	13,049	1,827
MB	-0,555	13,267	1,250	2,054
ROA	-0,139	0,293	0,079	0,076
CFO	-0,187	0,237	0,057	0,070
LEV	0,000	0,613	0,163	0,148
LOSS	0	1	0,209	0,407
BIG4	0	1	0,677	0,468
MERGER	0	1	0,155	0,362
BSIZE	5	15	9,174	2,272
BI	0	88,888	34,090	21,317
CEODUALITY	0	1	0,219	0,414
BLOCK	0	1	0,289	0,453
INV	0,000	0,448	0,135	0,123
REC	0,007	0,553	0,191	0,120

Table 2

Correlation matrix partner seniority/abnormal fees model

	ABNLAF	ABNLTOT	PTSEN	FTEN	PTTEN	SIZE	MB	ROA	CFO	LEV	LOSS	BIG4	MERGER	BSIZE	BI	CEO-DUALITY	BLOCK	INV	REC
ABNLAF	1																		
ABNLTOT	0.9037	1																	
PTSEN	0.0713	0.0814	1																
FTEN	0.1910	0.1694	0.0265	1															
PTTEN	0.1836	0.1575	0.1227	0.2737	1														
SIZE	0.0031	0.0175	0.0727	-0.1386	-0.0816	1													
MB	0.1240	0.1519	0.1328	-0.0098	0.0708	0.0037	1												
ROA	0.0393	0.0429	0.0270	-0.1191	-0.0001	0.2291	0.3284	1											
CFO	-0.0168	-0.0184	0.0207	-0.0521	-0.0398	0.2015	0.2218	0.8488	1										
LEV	-0.0168	-0.0076	0.1894	-0.0246	-0.0519	0.3780	0.0349	0.0165	0.0072	1									
LOSS	0.0289	0.0202	-0.0472	0.0925	0.0577	-0.2752	-0.0741	-0.6017	-0.6505	-0.0651	1								
BIG4	0.0952	0.1323	0.1714	-0.0956	0.0704	0.2456	0.1858	0.0882	0.0629	0.1131	-0.0448	1							
MERGER	0.0286	0.0219	-0.0256	0.0137	-0.0929	0.2530	0.0410	0.1263	0.1731	0.1201	-0.1270	-0.0307	1						
BSIZE	-0.0069	0.0180	0.0582	-0.0143	0.0196	0.5189	-0.0452	0.1539	0.1734	0.3090	-0.1063	0.0940	0.2040	1					
BI	0.0362	0.0715	0.0789	0.0369	-0.1291	0.3980	0.0307	0.0674	0.0274	0.2307	-0.0953	0.1985	0.1470	0.1998	1				
CEODUALITY	-0.0234	0.0232	-0.0905	0.0128	0.0245	-0.3031	0.0034	-0.0091	0.0287	-0.1188	0.0330	-0.1131	-0.1195	-0.2294	-0.1826	1			
BLOCK	-0.0157	0.0007	0.1460	-0.1198	0.0707	0.2743	0.1164	0.1434	0.1268	0.2938	-0.1568	0.1244	0.0412	0.2366	0.0656	0.0233	1		
INV	0.0664	0.0778	-0.1582	-0.0567	-0.0139	-0.2897	0.1512	0.0569	0.0300	-0.2927	-0.0675	-0.0255	-0.1376	-0.2304	-0.2962	0.3462	-0.0390	1	
REC	-0.0262	-0.0596	-0.1470	0.0786	0.0486	-0.4406	-0.0276	0.0035	-0.0188	-0.3538	0.0624	-0.1974	-0.0996	-0.2702	-0.1530	0.1329	-0.2483	0.2146	1

Table 3

Regression results for partner seniority/abnormal fees model

	ABNLAF		***ABNLTOT***	
	t-statistic	***coeff***	***t-statistic***	***coeff***
const	1,07	1,1068	1,30	1,8707
ptsen	2,10	0,0052**	2,38	0,0081**
ften	7,17	0,0516***	5,37	0,0538***
ptten	0,86	0,0063	-0,52	-0,0053
size	-1,88	-0,1520*	-2,05	-0,2299*
mb	0,61	0,0073	1.43	0,0237
roa	-0,45	-0,2128	-1,88	-1,2259*
cfo	-0,97	-0,3891	-0,71	-0,3957
lev	3,02	0,5121***	2,29	0,5403**
loss	-3,28	-0,1333***	-2,40	-0,1364**
big4	3,73	0,5455***	1,80	0,3669*
merger	-7,23	-0,2296***	-5,55	-0,2452***
bsize	1,02	0,0162	1,02	0,0226
bi	0,94	0,0015	1,23	0,0028
ceoduality	-0,43	-0,0280	1,27	0,1166
block	-0,54	-0,0292	-0,82	-0,0620
inv	0,89	0,4047	2,55	1,6121**
rec	-0,83	-0,3815	0,51	0,3264
Year-dummies	included		included	
Adj. R2	0,85		0,73	
F-stat	9,43		6,16	
Prob. (F-stat)	< 0,000		< 0,000	
N	412		412	

****, **, *** statistically significant at 10%, 5% and 1% , respectively (2-tailed test) – t statistic in parentheses***

ABNFEE represent the level of abnormal fee, as previously defined; PTSEN is the number of years that the auditor is partner in the audit firm; FTEN is the number of years that the auditor has audited the firm's financial statements since the beginning of the engagement; PTTEN is the number of years that the partner has audited the firm's financial reports, since the beginning of the engagement; SIZE is the natural log of total assets at the end of the fiscal year; MB is the market-to-book ratio, equal to market capitalization over shareholders' funds; ROA is the return on assets, equal to ebitda on total assets at the end of the fiscal year; CFO is the cash flow from operations scaled by total assets at the beginning of the fiscal year; LEV is total debts on total assets of the firm at the end of the fiscal year; LOSS is a dummy variable equal to 1 if the firm reports a loss, and 0 otherwise; BIG4 is a dummy variable equal to 1 if the firm is audited by a Big4 firm, and 0 otherwise; MERGER is a dummy variable equal to 1 if the firm is engaged in a merger or acquisition, and 0 otherwise; BSIZE is the number of members in the Board of Directors; BI is the percentage of independent directors in the BoD; CEODUALITY is a dummy variable equal to 1 when the CEO also holds the position of the Chairman fo the Board, and 0 otherwise; BLOCK is a dummy variable equal to 1 if the percentage of shares held by institutional investors are higher than 5 percent, an 0 otherwise; INV is total inventories on total assets at the end of the fiscal year; REC is total r receivables on total assets at the end of the fiscal year. We also include YEARdummies as year fixed effect.

Table 4

Descriptive Statistics for partner seniority on audit quality

	Minimum	Maximum	Mean	Std. Deviation
ABACC	0,005	0,908	0,422	0,177
PTSEN	1	39	14,666	8,037
FTEN	1	9	3,688	2,890
PTTEN	1	7	3,008	2,013
SIZE	8,732	17,424	13,042	1,827
MB	-0,555	13,267	1,250	2,054
ROA	-0,139	0,293	0,071	0,076
CFO	-0,187	0,237	0,057	0,070
LEV	0,000	0,614	0,163	0,148
LOSS	0	1	0,209	0,409
BIG4	0	1	0,677	0,468
MERGER	0	1	0,149	0,362
BSIZE	5	15	9,174	2,278
BI	0	88,888	34,090	21,317
CEODUALITY	0	1	0,212	0,414
BLOCK	0	1	0,289	0,453

Table 5

Correlation matrix for partner seniority/audit quality model

	ABACC	PTSEN	FTEN	PTTEN	SIZE	MB	ROA	CFO	LEV	LOSS	BIG4	MERGER	BSIZE	BI	CEO-DUALITY	BLOCK
ABACC	1															
PTSEN	0.0358	1														
FTEN	0.0829	0.0262	1													
PTTEN	0.0009	0.1626	0.2748	1												
SIZE	0.2553	0.0727	-0.1137	-0.0689	1											
MB	0.0657	0.1165	0.0158	0.0561	0.0138	1										
ROA	0.1398	0.0075	-0.0794	-0.0076	0.2417	0.3273	1									
CFO	0.2237	-0.0067	-0.0248	-0.0538	0.2117	0.2209	0.8438	1								
LEV	0.1587	0.1700	-0.0112	-0.0688	0.3897	0.0607	0.0580	0.0448	1							
LOSS	-0.1653	-0.0264	0.0598	0.0837	-0.2828	-0.0963	-0.6064	-0.6503	-0.0979	1						
BIG4	0.0962	0.1160	-0.0836	0.0089	0.2560	0.1955	0.1150	0.0778	0.1404	-0.0883	1					
MERGER	0.0477	-0.0262	0.0283	-0.0864	0.2358	0.0335	0.1185	0.1646	0.1384	-0.1081	-0.0396	1				
BSIZE	0.0592	0.0407	-0.0101	-0.0136	0.5133	-0.0395	0.1684	0.1958	0.3157	-0.1207	0.1318	0.2183	1			
BI	0.0270	0.0872	0.0183	-0.1263	0.3877	0.0289	0.0557	0.0098	0.2141	-0.0841	0.2112	0.1357	0.1943	1		
CEODUALITY	-0.1329	-0.0815	-0.0151	0.0139	-0.3037	-0.0049	-0.0405	-0.0008	-0.1346	0.0503	-0.1094	-0.1207	-0.2324	-0.1557	1	
BLOCK	-0.0008	0.1411	-0.1311	0.0642	0.2876	0.1199	0.1363	0.1107	0.2759	-0.1561	0.1318	0.0260	0.2243	0.0871	0.0331	1

Table 6
Regression results for partner seniority/audit quality model

	t-statistic	*coeff*
const	1,11	0,3480
ptsen	-0,33	0,0002
ften	1,04	0,0023
ptten	0,07	0,0002
size	0,40	0,0099
mb	1,22	0,0046
roa	-5,76	-0,7918***
cfo	5,67	0,7081***
lev	-0,21	-0,0109
loss	-1,24	-0,0157
big4	-0,80	-0,0351
merger	-0,15	-0,0015
bsize	0,00	0,0000
bi	-0,71	-0,0003
ceoduality	-0,11	-0,0021
block	-0,34	-0,0056
Year-dummies	Included	
Adj. R2	0,16	
F-stat	4,33	
Prob (F-stat)	0,0000	
N	416	

, **, *** statistically significant at 10%, 5% and 1% , respectively (2-tailed test) – t statistic in parentheses

ABACC is the absolute value of abnormal accruals; PTSEN is the number of years that the auditor is partner in the audit firm; FTEN is the number of years that the auditor has audited the firm's financial statements since the beginning of the engagement; PTTEN is the number of years that the partner has audited the firm's financial reports, since the beginning of the engagement; SIZE is the natural log of total assets at the end of the fiscal year; MB is the market-to-book ratio, equal to market capitalization over shareholders' funds; ROA is the return on assets, equal to ebitda on total assets at the end of the fiscal year; CFO is the cash flow from operations scaled by total assets at the beginning of the fiscal year; LEV is total debts on total assets of the firm at the end of the fiscal year; LOSS is a dummy variable equal to 1 if the firm reports a loss, and 0 otherwise; BIG4 is a dummy variable equal to 1 if the firm is audited by a Big4 firm, and 0 otherwise; MERGER is a dummy variable equal to 1 if the firm is engaged in a merger or acquisition, and 0 otherwise; BSIZE is the number of members in the Board of Directors; BI is the percentage of independent directors in the BoD; CEODUALITY is a dummy variable equal to 1 when the CEO also holds the position of the Chairman fo the Board, and 0 otherwise; BLOCK is a dummy variable equal to 1 if the percentage of shares held by institutional investors are higher than 5 percent, an 0 otherwise. We also include YEARdummies as year fixed effect.

Final considerations

We finally want to make some final considerations, basing on our knowledge on topics treated and the results of our quantitative studies.

In a general view, the study has the objective to improve the knowledge on the Italian audit market, highlighting positive aspects and recognizing the negative ones, giving some suggestions in order to improve the situation, for both scholars and regulators .

In particular, the results of the first quantitative analysis show that, under the Italian MAR regime, a longer tenure brings to higher fees, as higher abnormal fees, paid to the incumbent auditors. However, we find a positive relation between audit tenure and abnormal accruals; consequently, when tenure increases, the audit quality decreases.

The objective of the study is to demonstrate the efficacy of Italian regulation on Mandatory Audit firm Rotation. Basing on our results, we believe that it neutralizes the unfavourable effects that may derive from an unlimited duration of the audit appointment, such us the loss of integrity and independence for the overfamiliarity between the parts, or the expectation of future increasing profits.

Many countries in the world, such as USA, has not just mandated this rule, because they do not believe in the efficacy of it, implementing some other alternative rules. Therefore, the study would be a suggestion for regulators of other countries for their future decisions.

Moreover, with the second quantitative analysis, we introduce a new perspective in the study on partner's role. Specifically, we examine the effect of partner behaviours on audit job, when partner seniority increases. We draw on some peculiar cultural characteristics that epitomize the Italian context, such as the power distance and the gerontocracy.

The results of the first analysis demonstrate a significant and positive relation between partner seniority and abnormal fees, showing an increasing attention of partner to improve his

profits. This states that high partner seniority leads to high audit costs for clients, justified if it consequently leads to an improvement of audit quality. However, with the second analysis, we show there is not a significant association between partner seniority and audit quality.

Our suggestions regard the research on partner's role, with specific attention on studies on partner rotation, and its efficacy, and on studies examining the effect of cultural aspect on partner behaviour. Moreover, we suggest a growth of tasks for control bodies, as Consob in Italy, through a development of a specific task for the control of the assignment of audit firm and auditor to an engagement. The external and independent institution may have more power in a street control on the assignment of audit firm and partner to clients, when they incur in a mandatory rotation. In this case, they could avoid that free negotiations lead to an uncontrolled bargaining power of partners.

We hope this study could help regulators to provide for rules always more efficient, and researchers to develop future studies on these or other similar topics, advanced the international research.