Study Relationship between the Features of Auditor and Earnings Restatement: Some Evidences of Iran Capital Market

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ABSTRACT

The present study aimed to investigate the impact of auditor fee as one of the audit features on accounting restatements of the firms listed on TSE. This study applies classification and regression technique and the impact of audit fee was considered as the independent variable. The results of the study indicate that high fee is associated with high quality of audit. Other studies show that high fee can have adverse impact on auditor independence and reducing financial reporting quality. The present study aimed to evaluate the role of fee in quality of financial reporting of firms in Iran capital market. This study applies the financial statements information of firms listed on TSE during 2004 to 2012. The results of logistic regression analysis show the hypothesis of auditor independence defect and show that fee has positive and significant relation with accounting restatements. The results of the study don’t support the fact that increasing fee leads to improvement of financial reporting quality.

INTRODUCTION

The present study aimed to evaluate the relationship between auditor fee as one of the features of audit quality with accounting restatements. The purpose of financial statements is presenting summarized and classified information about financial status, financial performance and financial flexibility of business unit as useful for wide range of financial statement users to take economic decisions [2]. Net earnings are one of the most important items of financial statements considered as the criterion of performance evaluation criterion and profitability of business unit. As the calculation of profit is affected by authority of managers to use consistency, some of the studies evaluate effective factors on restatements. Some factors as changing managing director, auditor change, auditor industry specialization, auditor size and the greatest company shareholder with some relevant variables of firm features as cash flow ratio, liquidity ratio, firm size are associated with accounting restatements [17]. Jeffrey [8] believes that the increase of restatements is due to the high efforts of managers, board and auditors in reviews improving transparency and trust of investors. Regarding theoretical issues, more efforts of auditor lead to the increase of probability of detecting the mistakes and reduction of restatement probability [5]. This study evaluates the role of audit fee in accounting restatements as a criterion of financial reporting quality and the study of this issue can be of great importance in determining the reasons of low reporting of financial statements and avoiding numerous restatements.
The remainder of the paper is based on four following sections. The first section is regarding literature and study hypothesis. The next section is about study method. Then, descriptive statistics and study results are elaborated and finally the conclusion and recommendations are presented.

Theoretical literature and study hypothesis:

Empirical review of literature presents specific criteria to determine and evaluate earnings quality. High earnings quality improves capital market efficiency. Thus, investors and other users are interested in accounting information with high quality. Thus, accounting standards experts attempt to formulate the standards improving earnings quality. Earnings quality is used in various empirical studies in the past years to evaluate the changes in financial accounting standards and other institutions as corporate governance and comparison of financial reporting systems in various countries and the study of earnings quality on capital cost is also considered. Standard experts including financial accounting standard board and board of international accounting standards in the first part of their theoretical framework consider the need to high quality financial reporting [18].

Important factors of earnings quality are classified into six types in various researches:

a) Inherent features of firm, b) The financial reporting method, c) Governance features and internal control, d) Auditors, e) Capital market motivations, f) External factors [3].

Restatement is an important event indicating low quality of previous financial reporting and it indicates false management participation via weak corporate governance. The results of the studies in Iran regarding financial figures restatement and its effective factors show that high percent of Iranian firms restate financial statements due to modification of accounting mistakes and report a figure as annual adjustments [11]. This issue shows that accounting information of firms is doubtful regarding no mistake feature. The financial restatements of previous periods have various adverse outcomes as net earnings value is the basis of various calculations as board reward, tax and divided among the shareholders. In addition, the net profit value is the basis of decision making of most investors for decision making regarding share trading of firms and this restatement can have some problems for firms and auditors and their legal inspectors from legal aspects as auditors are responsible to give credits to financial figures and this issue can be problematic with financial restatements of values [9].

The results show that the firms being audited by big audit institutions have less discretionary accruals compared to the firms using other auditors [4]. On the other hand, high quality audit improves the validity of presented information and allow the investors to have exact estimation of firm value [16]. Thus, audit quality can be effective on restatement of financial statement figures. Direct measurement of audit quality in empirical studies has some challenges due to its non-observed nature with limited data. In these studies, indirect criteria of audit quality as auditor turnover and audit institution are used [19].

In a study regarding the evaluation of the role of independent auditors in reduction of discretionary accruals, it was shown that there was a positive and significant association between auditor size and reduction of discretionary accruals [6]. The results of another study showed that audited firms by great audit institutions have low accruals absolute value [1].

The literature of financial reporting quality shows that qualitative features of auditor is effective on financial reporting quality. Mehrani et al., [12] by three dimensions of prediction and support value, impartiality and discretionary (conservatism) based on theoretical concepts of Iran financial reporting as earnings quality evaluation criteria showed that tenure and auditor size had no significant relation with earnings quality. In another study, Mojtabazade and Babayi [13] found that there was an inverse relation between audit quality and earnings management. This study applies auditor industry specialization as auditor quality criterion.

Ebrahimi Kordler and Seyedi [6] in a study “the role of independent auditors in reduction of discretionary accruals” determined the relationship between independent auditors and auditor opinion with earnings management. Finally, their study results showed that only the type of audit institution was associated with discretionary accruals. Namazi et al., [14] in a study evaluated the relationship between audit quality and earnings management in the firms listed on TSE. Their findings showed that generally, there was a weak and positive association between auditor size (good reputation of auditor) and auditor tenure with earnings management. This relation was not significant statistically. Due to linearity problem in general model, the relationship between variables was investigated separately. The final results showed that there was a positive and non-significant association between earnings management and auditor size and there was a positive and significant association between earnings management and tenure.

Study hypothesis:

Based on study literature and above results, the study hypothesis is as follows:

H: "Audit fee has positive and significant association with accounting restatement".
Study method:

Study model:

The present study aimed to investigate the relationship between audit features and accounting restatements in the firms listed on TSE. The following model is used to test the study hypothesis.

\[
\text{Restate}_i = \alpha + \beta_1 \text{Fee}_i + \beta_2 \text{AuSize}_i + \beta_3 \text{Opi}_i + \beta_4 \text{Lev}_i + \beta_5 \text{Liq}_i + \beta_6 \text{Size}_i + \epsilon.
\]

Dependent variable:

In this study, restatement of firms is dependent variable as defined as dummy variable. If the firm restates in the required year, it is 1, otherwise it is zero.

Independent variables of study:

Auditor fee: It is measured as natural logarithm of auditor fee in the past year. It is expected that by increasing auditor fee, according to independence defect hypothesis, restatement probability of firm is increased.

In this study, to evaluate the relationship between auditor fee and accounting restatements, some control variables are used and based on research literature [17,15] can be effective on restatement probability. First variable is auditor size (AuSize). According to the studies in Iran, a dummy variable is applied and it is equal to 1, if the firm auditor was audit organization in the previous year, otherwise it is zero. It is expected that in big audit institutions, restatement probability is less. Auditor opinion (Opi) is a dummy variable and if auditor opinion was qualified in the previous year, it is equal to 1, otherwise it is zero. It is expected that auditor qualified opinion in the past year has direct and significant association with current year restatement of auditor. Financial leverage (Lev) is measured as long-term liabilities of firm to the assets in the past year. It is expected that by increasing liability in firm capital structure, restatement probability is increased. Liquidity ratio (Liq) is defined as the ratio of current assets to current liabilities of previous year of restatement. It is expected to reduce restatement in the firms with better liquidity condition. Finally firm size (Size) is considered as natural logarithm of the total sale of firm in the previous year and by increasing firm size, restatement is reduced.

Study population and sample:

The population in the study is all the firms listed on TSE during 2004 or before it. The study period is 2004-2012. To determine study sample, total available data are used. The financial firms and institutions are excluded from the final sample of study due to type of specific reporting. Finally, to eliminate the effect of outlier observations, the observations with higher than three standard deviations of mean are excluded from final sample. Based on above conditions, only 500 observations are selected in final sample to test the study hypotheses and they are used to evaluate study hypotheses.

Results analysis:

Descriptive statistics:

Table 1 indicates descriptive statistics of study variables. According to this Table, 65% of observations had earnings restatement and it showed that earnings restatement was a common phenomenon in Iran capital market. 23% of observations applied audit organization as their auditor and auditor opinion was qualified in 62% of study observations. Other information of descriptive statistics is shown in this table.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Min</th>
<th>Max</th>
<th>Mean</th>
<th>Median</th>
<th>Std. Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restate</td>
<td>0</td>
<td>1</td>
<td>0.65</td>
<td>1</td>
<td>0.497</td>
</tr>
<tr>
<td>Fee</td>
<td>3.91</td>
<td>8.21</td>
<td>5.65</td>
<td>5.21</td>
<td>0.68</td>
</tr>
<tr>
<td>AuSize</td>
<td>0</td>
<td>1</td>
<td>0.23</td>
<td>0</td>
<td>0.424</td>
</tr>
<tr>
<td>Opi</td>
<td>0</td>
<td>1</td>
<td>0.62</td>
<td>1</td>
<td>0.485</td>
</tr>
<tr>
<td>Lev</td>
<td>0.187</td>
<td>1.667</td>
<td>0.686</td>
<td>0.670</td>
<td>0.222</td>
</tr>
<tr>
<td>Liq</td>
<td>0.202</td>
<td>3.386</td>
<td>1.202</td>
<td>1.146</td>
<td>0.464</td>
</tr>
<tr>
<td>Size</td>
<td>9.41</td>
<td>16.82</td>
<td>12.72</td>
<td>12.60</td>
<td>1.253</td>
</tr>
</tbody>
</table>

Study hypothesis results:

Table 2 shows the results of study. Statistical power test supports model significance model (P=0.000) and it indicates good study model fitness. Also, predictive power of model is 60%. The results showed that there was a positive and significant association (P=0.000) between auditor fee and accounting restatements. These evidences are consistent with the study hypothesis. In other words, increasing fee can increase false reporting and restatement probability and lowering accounting information quality. Regarding control variables, the results show that current ratio is negatively and significantly associated with accounting restatement. This shows that the firms without liquidity problem have good reporting quality. The results are not significant regarding other variables. Despite others findings [6], the results of study show that there is no association between financial restatement and audit institution type. The coefficient between size of audit institution and restatement in this
study is consistent with the results of the study of Heninger et al., [7] supporting a positive relation. The review of literature shows that the bigger the audit institution, the higher the quality of audit and financial restatements are reduced but it is not observed in this study.

Table 2: Research results.

<table>
<thead>
<tr>
<th>Variable</th>
<th>β</th>
<th>Std. Err</th>
<th>Wald</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fee</td>
<td>0.002</td>
<td>0.001</td>
<td>10.638</td>
<td>0.000</td>
</tr>
<tr>
<td>AuSize</td>
<td>0.006</td>
<td>0.232</td>
<td>0.006</td>
<td>0.466</td>
</tr>
<tr>
<td>OpI</td>
<td>0.016</td>
<td>0.201</td>
<td>0.006</td>
<td>0.467</td>
</tr>
<tr>
<td>Lev</td>
<td>-0.481</td>
<td>0.786</td>
<td>0.375</td>
<td>0.252</td>
</tr>
<tr>
<td>Liq</td>
<td>-0.399</td>
<td>0.297</td>
<td>1.804</td>
<td>0.09</td>
</tr>
<tr>
<td>Size</td>
<td>-0.013</td>
<td>0.101</td>
<td>0.017</td>
<td>0.449</td>
</tr>
<tr>
<td>Constant</td>
<td>0.811</td>
<td>1.463</td>
<td>0.307</td>
<td>0.289</td>
</tr>
</tbody>
</table>

Discussion and Conclusion:

The relationship between auditor fee and quality of financial reporting of the firms listed on TSE is evaluated by earnings restatement in this study. High volume of restatements in Iran capital market requires the investigation of audit quality structure in these firms. By collected observations of financial information of the firms listed in TSE during 2004 to 2012, we evaluated the impact of auditor fee on quality of financial information of the firms listed on TSE. The results of the study showed that increasing auditor fee increased accounting restatement probability. Also, the results showed that by increasing firm liquidity, earnings restatement probability was reduced. The results of the study from theoretical aspect can deal with the review of literature of audit quality and audit feel and it also can reveal its role in quality of firms financial reporting. On the other hand, from applied aspect, it can receive much attention from auditors, creditors and investors regarding their contracts with firm. For investors, investment in the firms with high restatement can lead to information asymmetry risk and it should be considered.

REFERENCES


