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A Study of the Relationship between Audit Importance and Financial Reporting Quality: Evidence from Iran's Capital Market

Hasanali Ghanei[1], Seyed Mohammad Taghi Zabeti[2], Amin Nosrati[3]

[1]Accounting Master, Ferdowsi University of Mashhad, Iran
[2]Master student, Islamic Azad University, Mashhad Branch, Mashhad, Iran
[3]Master student, Attar Institute of Higher Education, Mashhad, Iran.

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ABSTRACT

The purpose of this study is to analyze the effects of the importance of the company being audited on the quality of financial reporting and auditing by independent auditors among the companies listed on the Tehran Stock Exchange (TSE). This study uses financial restatements to identify the low quality of reported accounting information in the previous financial statements of companies. Previous studies suggest that auditing quality and the properties associated with the auditing company are among the stimuli for financial restatements. According to studies conducted in developed and developing countries, one of the factors that can influence the occurrence of false reporting in a company is the economic importance of the company being audited to the revenue of the auditing institution. According to previous research in environments with poor supervisory reporting, it is expected that higher levels of economic importance are associated with lower levels of financial reporting quality by employers. This study uses data from financial statements of companies listed on the Tehran Stock Exchange during the years 2004 to 2012 to investigate the relationship between these two variables. The results of logistic regression analysis in support of the research hypothesis show that the importance of the company being audited has a significant positive correlation with the quality of financial reporting. Overall, the results of this study show that the employer can undermine the independence of the auditor to some extent.

***KEYWORDS*:** Financial reporting quality, financial restatements, audit importance.

1. INTRODUCTION

The purpose of this study is to analyze the effects of the importance of the company being audited on the quality of financial reporting and auditing by independent auditors among the companies listed on the Tehran Stock Exchange (TSE). Previous studies have provided conflicting results in relation to the impact of client importance on the quality of corporate financial reporting. On the one hand, it is suggested that audit firms are not willing to lose their relation to large employers because of their dependence on them. As a result, the quality of reporting in these companies is likely to be lower (Ferguson et al., 2004). On the other hand, there is the issue of keeping a reputation by audit firms. It is suggested that audit firms are not willing to lose their reputation by manipulating a decreased financial reporting quality on the part of the employer in order to not lose that employer (e.g., Crasewell et al., 2002). Thus, there are two opposing views in relation to the impact of the economic importance of clients on auditor independence: economic dependence theory and reputation maintenance theory.

This study seeks to answer the question whether auditors maintain their independence in auditing larger and economically more important companies or not. Using the criteria of employer's selling rate and audit fees to measure client importance (according to Reynolds and Francis, 2001; Chung and Kallapur, 2003) and using logistic regression analysis based on collected samples from among the companies listed on the Tehran Stock Exchange during the years 2004 to 2011, the results of this study show that client importance is significantly and positively associated with financial restatements as a negative measure of corporate financial reporting quality. In other words, it can be concluded that the economic importance of clients in Iran's capital market affects the quality of financial reporting. Also, after controlling other factors that could affect financial reporting quality, we found that the distribution probability of financial restatements is positively associated with the size of the company and the change of the auditor. Overall, the results of this study show that the employer can undermine the independence of the auditor to some extent.

The remainder of this paper is divided into four sections. In the first part, the discussion is focused on the research literature and hypotheses development. In the next section, the research methodology is presented. Then,

*** Corresponding Author:** Hasanali Ghanei, Accounting Master, Ferdowsi University of Mashhad, Iran (Acc.ghanei@yahoo.com)

the descriptive statistics and research results are presented, and the paper ends with conclusions and recommendations.

2. Literature Review and Hypothesis Development

Considering the changes in accounting principles and methods resulting from constant changes of economic and social conditions as well as due to the complexity and high volume of commercial transactions, it seems inevitable to have mistakes in financial reporting. According to clause 42 of the standard no. 6 of Iran accounting for the cases when the financial statements were published in one or several former cycles, it has important mistakes that tarnishes the proper image and as a result reduces the ability to rely on the mentioned financial statements. Modification of such mistake should not be made by adding it to the profit and loss of the current year, but should be obtained by restatement of figures of financial statements of the former years for this purpose. That is why restatement can be considered as a shortage or loss that was explored in current year, of course provided that it is not as a result of the change in accounting procedure. The studies have also shown that a high percentage of restatements of financial statements in Iran are due to amendment of accounting mistakes (Kurdistani et al, 2010).

As an external corporate governance mechanism (Baber et al., 2010), independent auditors are directly involved in the financial reporting process and can have a significant impact on the quality of accounting information. The quality of provided auditing services is one of the main issues in the auditing industry. Higher levels of auditing quality reduce the uncertainty associated with financial reports provided by the managers. The role of auditing in the validation of companies' income information following recent restatements of income and the bankruptcy of large companies has gained a considerable importance. Differences arising from different auditing qualities emerge in the validity provided by the auditors and the income quality of their employers.

Restatement of financial statements from the viewpoint of investors not only indicates the problems of performance of former cycles, but also is a kind of anticipation of the future problems for the company and its management. On the other hand, independent auditors enjoy a special position in the governance structure of the company and play a sensitive role to promote the quality of financial reporting that could be distorted due to restatement of financial statements resulting from mistake (Hassas Yeganeh and Baghomian, 2005). On this basis audit quality can affect the quality of financial reports.

Jeffry, 2008 believes that increased restatements of financial statements is because of the massive efforts of the directors, board of directors and auditors to make reviews and that causes improvement of transparency and trust of investors. It has also been raised in the theoretical topics that more attempts by auditor leads to increased possibility of discovering mistakes and as a result reduction of possibility to represent financial statements (Hillegeist, 1999). The role of auditing to reduce the misstatements is not the only topic of auditing studies, but also has deep experimental concepts.

Li (2009) found that economic agreements between audit firms and clients could affect their independence such that the level of pressure increases by the employer. In fact, the auditor is concerned on the one hand with retaining and attracting clients and on the other with the occurrence of failures in performing audit procedures that may lead to subsequent financial losses and damage to its reputation. Thus, low quality auditing can improve the reputation of the auditor and the maintenance and acquiring of new clients (Reynolds and Francis, 2001). Thus, there are two opposing views in relation to the impact of the economic importance of clients on auditor independence: economic dependence theory and reputation maintenance theory.

A large number of theoretical and empirical researches suggest that due to the issue of audit firms' reputation and cost of claiming against them, auditors have market-based and intrinsic incentives to act independently (see Li, 2009). For example, Craswell et al. (2002) investigated the relationship between auditor fee dependence, as measured by the ratio of the client audit fees to total audit firm fees, and tendency towards revealing qualified audit report using data from Australian companies over the period of 1994 to 1996. They found no relationship between audit fees and qualified audit opinion.

In support of this hypothesis, Ebrahim (2001); Zhou and Zhu (2012); Chi et al. (2012) as well as Omidfar et al. (2013) found no significant relationship between client importance (measured by the employer's selling rate) and the adjusted auditing report. According to Omidfar et al. (2013), audit quality and independence in Iran's capital market are not affected by the economic importance of clients. Using data from Australian companies during the years 1994 to 1996, Crasewell et al., (2002) studied the relationship between audit fee dependence, measured by the ratio of client audit fees to the total audit fee, and the tendency to distribute the qualified audit report. They found that there was no relationship between audit fee dependence and the qualified audit report. Using the ratio of non-audit and audit fees to the total audit firm income in another study, Chung and Kallapur (2003) did not find a significant relationship between client importance and earnings management.

The results of a study by Li (2009) also oppose the idea that higher fees compromise the independence of auditors in connection with their reports. Li found that there was no significant relationship between the ratio of audit and non-audit fees to the total audit and non-audit fees and the qualified reports for firms with financial stress in the period prior to the implementation of the Sarbanes-Oxley Act (SOX). The results also showed that this relationship was positive even after the implementation of the SOX. Also, Chen et al. (2010) used a sample of companies in China for the period before and after the implementation of the SOX in 2001 and found that client importance after the change was positively associated with qualified audit reports.

Reynolds and Francis (2001) also used data through 1996 to study the issue whether the big client's authority affects the 5-Big auditor reporting decisions or not. Client authority is measured as the net ratio of client sale over total net sales of all clients audited by that auditor. They found that client's authority is negatively related to discretionary accruals and positively related to auditor's going-concern. This suggests that the 5-Big auditors are more conservative than larger clients in expressing opinion. Chung and Kallapur (2003) also used the ratio of audit and non-audit fees to audit firm's total income and found no significant relationship between the client importance and earnings management. Chen et al. (2010) also used a sample company in china for periods before and after the enactment of the rule of governance in 2001, and found that the client importance was negatively related before the situation changes and after that positively related to auditor's adjusted opinion.

Despite the issue of reputation maintenance for the audit institutions, yet there are pressures that can threaten the independence of the auditor. There are researches on this issue that indicate that the client economic importance reduces audit quality. For example, Ferguson et al. (2004) used data from UK companies and found that the amount of non-audit services' fees of certain clients with discretionary accruals and the probability of further renewal are more dependent. Similarly Basioudis et al. (2006) found that the more non-audit fees are more dependent on lower audit qualified opinion for firms with financial stress.

In this connection, research shows that client importance reduces audit quality. Using data from British companies, Ferguson et al. (2004) and Kinney et al. (2004) found that the amount of non-audit service fee for specific clients is associated with higher levels of discretionary accruals and higher probability of restatements. Similarly, Basioudis et al. (2006) found that higher levels of non-audit fees are associated with lower levels of qualified auditing report for firms with financial stress. In a study in China, Gul et al. (2007) concluded that employers with higher economic importance to auditors have a lower auditing quality. In another study in Greece, Spathis et al. (2007) and Gaganis et al. (2007) found that there is a direct relationship between audit fees and valid reporting.

Since auditing quality has different dimensions and is inherently unobservable, there are no certain auditing characteristics that can be considered as a measure for it. Previous studies have enumerated such auditing criteria as auditor reputation, auditor changes, auditor tenure, auditor size, and auditor industry specialization as representatives of quality auditing. Evidence suggests that industry specialist auditors provide more effective auditing. In addition, structural changes in audit firms to achieve industry specialization suggest that industry specialization has an important impact on auditing quality (Etemadi et al., 2009). The purpose of this study is to empirically examine whether auditor industry specialization has a significant impact on auditing quality (as measured by financial restatements) or not.

Hypothesis: Client importance is positively associated with the probability of the financial restatement of accounting profit.

3. METHODOLOGY

3.1 Research Model

To study the relationship between the economic importance of clients and the probability of financial restatement, the following regression model has been used:

$$Restate_t = \beta_0 + \beta_1 Import_{t-1} + \beta_2 AuSize_{t-1} + \beta_3 Switch_t + \beta_4 OPI_{t-1} + \beta_5 Size_{t-1} + \beta_6 Liq_{t-1} + \beta_7 LEV_{t-1} + \beta_8 Loss_{t-1} + \beta_k \sum_{k=9}^{16} Years + \beta_j \sum_{j=17} Industries + \varepsilon.$$

3.2 Research Variables

Financial Restatement (Restate): The dependent variable – This variable is valued as 1 if a company's financial statements for the preceding fiscal period are restated; otherwise it is valued as zero.

Client Importance (Import): To measure this variable, according to Reynolds and Francis (2001) and Chung and Kallapur (2003), we use the natural logarithm of sales [1] as a measure of client importance, as presented in the

[1] Because of inflation in Iran, the amount of total assets has not been used.

following equation:

$$CI^{O} = \frac{\mathrm{Ln}TAST_i}{\sum_{i=1}^{n} \mathrm{Ln}TAST_i},$$

Whereby, $LnTAST_i$ is the natural logarithm of sales by the client i and their sum is the sum of the natural logarithm of total sales by all clients analyzed by a specific auditor in a specific year. In an additional test, we used the audit fee income measure to calculate client importance.

In a similar manner to previous studies, in addition to the variables under study, this study also uses other variables that can affect financial restatements as control variables. In this connection, Nonahalnahr et al. (2010) found that companies audited by auditors with higher levels of quality are characterized by more stable coefficients on accruals and subsequently by higher levels of accrual reliability. Thus it can be argued that the practice of earnings management in firms with higher levels of auditing quality is more limited which can lead to a lower probability of financial restatement. In this study, as in previous studies (e.g., Sajjadi et al., 2009), audit institutions are divided into two classes: "audit firms" and other institutions. For this purpose, this variable is valued as 1 if the auditor in the previous year was an "audit firm"; otherwise it is valued as zero (AuSize). Auditor changes as another control variable is valued as 1 if the auditor has changed in relation to the previous year; otherwise it is valued as zero (Switch). Auditor changes can also increase the probability of financial restatement (Farber, 2005). Numerous studies show that qualified statements of the auditor for the preceding fiscal period are one of the factors that affect financial restatement (see, Farber, 2005). Thus, this variable is valued as 1 for a company that has received a qualified statement (OPI) in the preceding fiscal period; otherwise it is valued as zero. According to previous studies, larger firms are more likely to manipulate their financial statements (Agrawal and Chandha, 2005). Thus, a positive relationship is expected for this variable (SIZE). In this study, we have used the natural logarithm of corporate sales to measure this variable.

Many studies show that financial risk is the standard leverage and the level of debt represents risk (Chen et al., 2006). Thus, according to this view (the risk hypothesis); if there are high levels of debt, companies are more likely to provide false financial statements (Richardson et al., 2002). In this study, this variable (LEV) is calculated by dividing total liabilities by total assets at the end of the fiscal period in the year of financial restatement. According to Cao et al. (2009) and Chen et al (2006), companies that have suffered losses try to improve it by providing false statements which manifests itself by the occurrence of restatements. For this purpose, we define the variable of Loss. This variable is valued as 1 if a company has suffered losses in the year before financial restatement; otherwise it is valued as zero. Also, the control variable of Years includes a set of dummy variables that are considered to control the effects of each year and the control variable of Industries includes a set of dummy variables that are considered to control the effects of each industry.

4. ANALYSIS OF RESULTS

4.1 Descriptive Statistics

Table 1 presents descriptive statistics on the study variables. According to this table, 65% and 62% of the observations have financial restatements and qualified statements, respectively. The table also shows that 23% of the sample companies have used audit firms as their auditor and 20% of the sample companies have experienced auditor changes. Finally, it can be concluded that companies reported an average of 8 percent loss in the preceding fiscal period. The following section provides the results of tests on the research hypotheses.

Table 1. Descriptive statistics

Variable	Min	Max	Mean	Median	Std. Dev
Restate	0	1	0.65	1	0.479
Import	0.001	1	0.452	0.327	0.388
AuSize	0	1	0.23	0	0.424
Switch	0	1	0.20	0	0.401
OPI	0	1	0.62	1	0.485
Size	9.41	16.82	12.72	12.60	1.253
Liq	0.202	3.386	1.202	1.146	0.464
Lev	0.187	1.667	0.686	0.670	0.222
Loss	0	1	0.08	0	0.275

4.2 Research Findings

Table 2 provides the results of tests on the research hypothesis in relation to the relationship between client importance and financial reporting quality using the measure of restatements of accounting income for 1095

observations of fiscal period-company. According to this hypothesis, the economic importance of clients has a significant positive correlation with the probability of restatements of accounting income. Evidence suggests that client importance has no significant correlation with financial restatement (P-value = 0.231). At the same time, as in the research hypothesis, the sign of this variable is positive. Other results show that the variable of auditor changes is positively associated with restatements of accounting income (P-value = 0.010). This suggests that the probability of financial restatement increases with the change of auditor. From among the variables related to firm characteristics, the variable of firm size is associated with restatements. The results show that this variable has a positive and significant relationship with financial restatement (P-value = 0.071). In other words, the probability of accounting restatement is higher for larger firms. Some variables of the model have a negative sign. Among these variables, the current ratio is significant and the variables of leverage and performance in the preceding fiscal period are not significant. According to research evidence, the probability of restatement decreases with increased liquidity in firms (P-value = 0.069). Also in this study, the variables of audit institution type and auditing reports have a positive but non-significant relationship with financial restatement.

Table 2. Research results

Variable	β	Std. Err	Wald	Sig.
α	-0.837	1.144	0.535	0.232
Import	0.162	0.219	0.544	0.231
AuSize	0.187	0.199	0.882	0.174
Switch	0.427	0.183	5.435	0.010
OPI	0.092	0.150	0.381	0.271
Size	0.097	0.066	2.144	0.071
Liq	-0.297	0.201	2.187	0.069
Lev	-0.038	0.516	0.006	0.471
Loss	-0.219	0.277	0.625	0.215

4.3 Additional Test on the Variable of Client Importance

In the original model of the study, the companies' sales audit is used as the measure of client importance. In this section, an additional test uses the measure of audit fee to calculate client importance. Table 3 presents the results of logistic regression analysis with the variance of the variable of client importance. Due to limitations in data collection related to audit fee, this model was implemented using 515 observations of fiscal period-company for companies listed on the Tehran Stock Exchange. The results of tests on this variable show that client importance is positively associated with financial restatement (P-value = 0.069). In other words, an increase in client importance (due to higher audit income) increases the probability of financial restatement. In addition, similar to the results of the previous model, the results of tests on the variable of auditor changes show that it is positively associated with financial restatement. In other words, a change of auditor increases the probability of accounting restatement. In this model, the variable of auditor changes is also significant. According to the evidence presented in Table 3, the variable of auditor changes is positively associated with financial restatement (P-value = 0.027). In other words, if audit firm is the auditor of a company, it increases the probability of financial restatement. From among the variables related to firm characteristics, none is significant in this model. However, the signs of the variables of firm size, liquidity and yield of the preceding fiscal period are similar to the previous results.

Table 3. Additional Results

Variable	β	Std. Err	Wald	Sig.
α	-0.502	1.706	0.087	0.384
Import	0.492	0.343	2.049	0.075
AuSize	0.607	0.314	3.722	0.027
Switch	0.692	0.284	5.957	0.007
OPI	-0.009	0.222	0.002	0.485
Size	0.055	0.110	0.248	0.309
Liq	-0.032	0.329	0.010	0.461
Lev	0.347	0.821	0.179	0.353
Loss	-0.160	0.482	0.627	0.214

5. DISCUSSION AND CONCLUSIONS

This study used a set of control variables to address the relationship between the economic importance of

clients and financial reporting quality through the measure of restatement of accounting income. The purpose of this research was to answer whether the economic importance of clients can reduce the independence of auditors in Iran's capital market. Some previous studies have reported a positive relationship and some others a negative relationship. To answer this question, unlike the study by Omidfar et al. (2013) which used the variable of sales as the measure of economic importance of clients, this study used the amount of audit fee paid to auditors as the measure of client importance. The results of previous studies using these two criteria are different. Overall, the results show that client importance increases the probability of accounting restatement. According to the results of this study, the economic importance of clients using the measure of audit fee has a positive and significant relationship with the probability of restatement of accounting income. However, no significant relationship was found in relation to the measure of audited sales of the client. The results of this study are consistent with the results of studies by Reynolds and Francis (2001), Ebrahim (2001), Crasewell et al. (2002), Chung and Kallapur (2003), Li (2009), Zhou and Zhu (2012), Chi et al. (2012) and Omidfar et al. (2013) and inconsistent with the results of studies by Basioudis et al. (2006), Spathis et al. (2007) and Gaganis et al (2007).

Regarding the control variables, evidence suggests that the variables of auditor changes and firm size are positively associated with financial restatement. In other words, larger firms and firms with an experience of auditor change are more likely to perform financial restatements. The results of this study can be important from two perspectives. From the perspective of applicability, it can assure capital market investors and policymakers that the independence of auditors is not compromised by client importance and that they can rely on the statements issued by auditors. In terms of the limited availability of data on auditing fees in the financial statements of companies, it is also suggested that additional measures be adopted for more detailed reporting of the costs by companies listed on the Tehran Stock Exchange. From the theoretical perspective, this study adds to the literature on auditor independence and client importance. In addition, this study can motivate researchers to further explore the issue of client importance which has not yet been addressed by studies in Iran. Also, it can reveal a fairly confident about the overall level of audit quality and also they support previous researches and confirm that audit quality in larger audit firms is lower than other institutions. Also, this study can contribute to the research literature on audit opinion. Understanding factors affecting audit opinion in the capital market of Iran can help policymakers in Tehran Stock Exchange to monitor the quality level of market. Examining other factors that affect the audit opinion with emphasis on the number and type of qualified opinion sections and using other methods of analysis can be placed on the agenda of future researches.

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