

Investigating the Relationship between Audit Quality and Profit Management

Case Study: Companies Accepted in Tehran Stock Exchange

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ABSTRACT

The present research has been performed aiming to investigate the relationship between audit quality and profit management in the companies accepted in Tehran Stock Exchange. The data and information required for doing this research are collected from different sources according to their type. Information related to research literature and theoretical topics have been collected from library resources, academic bases, and foreign and domestic articles. The data needed to calculate research variables have been extracted from "TadbirPardaz" and "RahavardNovin" databases. The Excel and Eviews software have been used to calculate and prepare data for the required research data as well as their analysis. The findings of research indicate a negative and significant relationship between profit management and audit wage. Also, the relationship between profit management and company's size was not accepted and was not confirmed..

Introduction

Investing is one of the primary needs for crossing from an undeveloped economy towards a developed economy. Undoubtedly, in order to direct the capital of those who are interested in investing we need to attract their trust. To this end, the investors want information that will help them to perform a successful investment. Financial statements are considered as the most important part of the financial information set. But an important issue is the doubt about the ability to rely on the aforementioned information that comes from the conflict of interests. In addition to the conflict of interests, other issues, such as the lack of direct access of users to the information, have led to the demand for independent audit services. In fact, the role of audit is to assess the quality of information for users. The accounting profit and components related to it are considered as information that at the time of decision making are considered by people. This figure is calculated and identified on the basis of accruals (EbraheemSaleem Salem Alzoubi, 2016). Although the main responsibility for the preparation of financial statements is upon the management of company, in the wake of recent worldwide financial scandals and the emergence of concerns about the reliability of financial statements, the accusation, as far as it is generally mentioned, has pointed to the auditors. The "Audit Failure" of events as a general is that the lack of independence and the poor quality of auditor have caused such events to occur (Li, 2007). The audit process is, in fact, one of the ways to specify the credibility of financial statements. With the growth of competition in the profession, audit institutions have found out the necessity of offering their services with the best quality to the market more, and to compete on a basis other than wage, audit institutions seek to make their services different. Therefore, the quality of auditor is of special importance to the users. Considering that the privatization process has been relatively more accelerated with the implementation of Article 44 of the Constitution, the necessity to audit the financial statements of these companies with high quality in order for their stocks to be accepted in the Tehran Stock Exchange for increasing the reliability and transparency of information in it seems to be necessary, and despite the incentives of managers to apply profit management, it is necessary to investigate and specify the relationship between audit quality and profit management in order to provide information for better decision making of the users of these statements. This research can be considered by shareholders, investors, and creditors as a new criterion in helping to make decision and offer appropriate solutions. Therefore, the research question is compiled as 4

to what extent is there relationship between audit quality and profit management in the companies accepted in Tehran Stock Exchange?

Research History

EbraheemSaleem Salem Alzoubi (2016) conducted a research entitled as Accounting Quality and Profit Management: Observations from Jordan. This article reveals that there is a negative and significant relationship between audit quality and profit management. The results point to the fact that, by using independent auditors' services, the level of profit management among companies is significantly reduced (is lower). In addition, this study shows that the level of profit management is significantly lower among companies that hire a large audit company, which is comparable to those companies that do not use the services of large audit companies.

Denis and Pascale (2012) in a research entitled as The Impact of Corporate Governance on Profit Management investigated the impact of corporate governance on profit management in initial public offering companies. They found out that the companies with a better corporate governance mechanism are less likely to use profit management to achieve predicted profits.

Inaam (2012) in a research entitled as Audit Quality and Profit Management in Tunisia, investigated the impact of audit quality (auditor size, expertise of auditor industry, and auditor's tenure) on limiting the ratio of actual profit management (manipulation of actual activities) and profit management based on accruals. The results of their research indicate that the expert accountants of industry and the auditors of four large auditing institutes are related to lower levels of profit management based on accruals. There is also a positive and significant relationship between the auditors of four large auditing institutes and the ratio of actual management profit. In addition, they found out that an increase in the auditor's tenure was not related to the actual profit management based on more accruals.

Safari et al. (2011) in a research entitled as The Effect of Audit Quality on Profit Management investigated the effect of audit quality on discretionary accruals as a criterion for measuring profit management. They used three criteria of auditor's size, the expertise of audit industry, and auditor's independence to measure audit quality and 5

concluded that discretionary accruals have reverse relationship with the auditor's size, the expertise of audit industry, and the independence of auditor.

Jerry and Lin (2010) in a research entitled as Audit Quality, Corporate Governance, and Profit Management used three criteria of auditor's size, the expertise of audit industry, and auditor's tenure to measure the audit quality, and found out that these criteria have a negative relationship with profit management.

Rusmin (2010) in a research entitled as Audit Quality and profit Management investigated the effect of auditor's quality on profit management. He found out that there is a reverse relationship between the auditor's quality and profit management, in a way that by increase in the auditor's quality, the profit management decreases.

Chang et al. (2010) in a research showed that when companies release bonds convertible into stocks, there is no significant relationship between profit management and mentioned bonds. In other words, they found out that when convertible bonds are released, the quality of accounting information is not reduced through profit management.

Choi et al. (2009) in investigating the impact of institutions' size and quality and the wage of auditing found out that the size of institutions has a direct relationship with the audit quality as well as their wages. In other words, they showed that large audit companies are different in terms of wage and audit quality compared to small audit institutions.

Cameran et al. (2008) showed that the relationship between profit management and audit quality during the time has been reduced through profit management increase. They also found out that the audit quality reduces by the auditor's optional change.

Chen et al. (2005) in a research by selecting 4 large audit companies as high quality auditors found out that there is a significant relationship between the profit management and the auditor's size, in the way that the larger audit companies lead to the reduction of profit management in these companies.

Myers et al. (2003) concluded in their research that the longer the auditor's tenure is, the higher his knowledge of his employer and specialty in that particular industry, and causes the enhancement of audit quality.

Zhou and Elder (2003) found out that there is a relationship between the auditors of five large audit companies and the professional auditors of industry with less profit

management in the initial public offering companies. In their research, the size of auditor and the auditor's tenure are considered as the indicators of auditor's quality. The reason for using these two variables also emphasizes the distinction between the concept of auditor quality and the concept of audit quality. Since many factors affect the audit quality, it is considered important to establish a framework for determining the quality of subject auditing.

Research Hypotheses

- 1) There is a negative relationship between profit management and audit wage.
- 2) There is a negative relationship between profit management and the size of Audit Company.

Research Method

The data and information required for doing this research are collected from different sources according to their type. Information related to research literature and theoretical topics have been collected from library resources, scientific bases, and foreign and domestic articles. The data needed to calculate research variables have been extracted from "TadbirPardaz" and "RahavardNovin" databases. The Excel and Eviews software have been used to calculate and prepare data for the required research data as well as their analysis. In this research, multivariate linear regression model has been used to test the hypotheses. The statistical method used in this research is the combination data method. In this case, in order to estimate the model based on panel data, there are various methods, such as the method of Fixed Effects and the method of Random Effects that will be applied according to the case. In this research, our statistical population is all companies accepted in Tehran Stock Exchange.

In this research, a systematic elimination method has been used so that the statistical sample is an appropriate representative of the desired statistical population. For this purpose, 3 following criteria are considered and if a company has met all the criteria, it will be selected as the research sample and the remaining ones will be deleted. (Number of statistical population is 425 banks). 7

The financial information of companies should be available. For this purpose it is necessary for the company to be accepted in the stock exchange before the year 2012 and to be active in the stock exchange until the end of 2016.

The fiscal year of company will be ended at March 20 and should not have the fiscal year change during the years 2012-2016.

They should have continuous activity between the years 2012-2016.

Eventually, 112 companies were selected.

How to Calculate Research Variables

The dependent variable of research includes profit management, which is measured through discretionary accruals. In order to estimate discretionary accruals, the modified Jones model (presented by Dechow, Sloan, and Sweeney, 1995) is used, this model is as follows:

$$TACC_{it} / TA_{it-1} = a_0j (1 / TA_{i, t-1}) + a_1j (\Delta RE_{Vi, t} / TA_{i, t-1}) + a_2j (PPE_{it} / TA_{it-1}) + e_{it}$$

TACC_{it} = Accumulation accruals (profit before unexpected items minus cash flowsoperational) in the year t for the company i

TA_{it-1} = Total assets of company i in the year t-1

$\Delta RE_{Vi,t}$ = Income changes during the year t-1 for the company i

PPE_{it} = Net amount of properties, machineries and equipments in the year t for the company i

The independent variable is the audit wage that for calculating the audit wage of company i, the normal logarithm of auditor wage of that company in the year t has been used.

The second independent variable is the size of company, which is equal to the net assets of company. 8

Findings

In order to choose among the methods of Integrated Least Squares, Fixed Effect and Random Effect, the tests of Chow and Hausman have been used. The results of these two tests are presented in table 1. Based on the significance level obtained, the fixed effects model is the best model for estimating regression.

Table 1: Results of Chow, Lagrange Multiplier, and Hausman tests **Test Type Test Statistics Significance Level Test Result**

Chow Test	16.08	0.0000	Fixed effect model against combination data model is confirmed.
Hausman Test	6.62	0.0365	Fixed effect model against random effect is confirmed.

Source: Research Data

Table 2: Results of Fixed Effect Model **Descriptive Variable Dependent Variable: Liquidity Coefficient t Statistics P-value**

Company's size	-1.258578	-0.434738	0.6640
Audit wage	-282.2106	-14.60262	0.0000
Width from source	8238.290	67.40463	0.0000

F statistics
95.67
P-value
0.000
R2
0.96
Justified R2
0.95
Durbin–Watson
1.54
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As it is observed, the audit wage has a significant relationship with the profit management, because the statistic p is less than 0.05. But the size of company is not that way. However, the relationship of both of them with the profit management is negative, so the first hypothesis of research indicating negative relationship between profit management and audit wage is confirmed and the second hypothesis indicating negative relationship between profit management and company's size is rejected.

Also, the overall estimation results of model show that with 1 unit change in audit wage, the profit management is reduced by 0.95 units, that this coefficient is a significant coefficient. The Durbin–Watson statistic is also at appropriate limitation.

Discussion and Conclusion

In this research, the relationship between audit quality and profit management has been investigated. The results of research showed that there is a negative relationship between the profit management and the audit wage and the size of audit company. Also, the relationship between profit management and audit wage was not accepted. The findings of this research are consistent and correspond with the research findings of EbraheemSaleemSalemAlzoubi (2016), Chang et al. (2010)Rusmin (2010), and Cameran et al. (2008).

Considering the influence of auditor's specialty on the profit management of companies, it is suggested that the users of financial statements take into account their auditor's expertise when analyzing audited companies. Industry expertise auditors should also be aware of the fact that their ability to limit accruals management indirectly forces the employers to take operational decisions in the long term to divert from optimal decisions. It is suggested that the expert auditors make more communication with managers. Also, due to the lack of distinction between the audit organization as a large audit company and other audit companies in influencing the profit management of companies, which indicates the ineffectiveness of Audit Company's size, financial statements users, when analyzing audited companies, investigate other factors influencing on the accruals management of companies. According to the results of this research, it is suggested for future researches to use other quality audit criteria in previous performed researches such as visiting independent partner auditor and senior manager from audit work stages, the 11

importance of audit wage for the audit institution, audit efficiency, detection of significant distortions, conflict of interests, as well as the existence of laws, regulations, and mechanism of market,

and to investigate their power to explain the size of audit company and auditor's expertise in influencing the profit management of companies. 11

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