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    STATEMENT OF THE PROBLEM

    OBJECTIVES

    HYPOTHESES

    RESEARCH METHODOLOGY

    RESULTS & DISCUSSION

    FINDINGS

    RECOMMENDATIONS/SUGGESTIONS

    CONCLUSIONS

    SCOPE FOR FURTHER RESEARCH

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EFFECT OF AUDITOR QUALITY ON EARNINGS MANAGEMENT IN COMPANIES LISTED ON TEHRAN SECURITIES EXCHANGE

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ABSTRACT

Purpose of this research is to examine effect of auditor quality on earnings quality. Kasznik Model was used for estimating earnings management (abnormal accruals). Auditor quality is a two-valued dummy variable. In this variable, audit organization has value one and other firms have value zero. Time period of this research was 4 years during 2005-2008. Research hypothesis was tested using cross-sectional regression approach in each year and using panel data. Results of research indicated that there was a negative significant relationship between auditor quality and earnings management. Hence, it can be concluded that existence of high-quality auditors results in decreasing earnings management opportunities.

KEYWORDS

Auditor Quality, Earnings Management, Abnormal Accruals.

INTRODUCTION

Presentation of information, which is useful for current investors, creditors, and other current and potential users in decision makings related to investment and crediting and other decisions is one of the objectives of financial reporting. Current and past earnings of company is one of the important factors, which groups in question implement for estimating profit-making power of company, predicting future earnings and pertinent risks, and also evaluating management performance.

In addition, earning is comprised of cash items and accruals. Earnings accruals are mainly controlled by management and management can modify accruals and how they call it nowadays he can manage profit for embellishing company's performance and increasing predictability of future profits. In other words, managers attempt to create predictable and stable results through selecting licensed accounting methods. Since most of investors and mangers believe that the company with appropriate profit-making trend and no main changes in their profits are more valuable and have more predictability and comparability as compared to other similar companies. On the other hand, according to agency theory, managers can enjoy necessary motivation for manipulating profit for maximizing their own benefits. Implementation of big accounting firms of high quality in auditing financial statements is one of the best and most reasonable approaches for assuring of suitable quality of financial statements. De Angelo defined auditor quality as follows: "market assessment" with a probability of auditor (1) identifying significant misstatements in financial statements or in accounting system of employer and (2) reporting detected noticeable misstatements. Probability of auditor detecting significant misstatements and probability of auditor reporting significant misstatements depend on auditor's competence an independence. Numerous investigations examined relationship between auditor quality and earnings management. Baker (1998), Francis (1999), Defond and Jiambalvo (1991 and 1993), and Gore (2001) in their investigations in state companies concluded that auditor quality reduced likelihood of earnings management occurrence. Also Baker, Defond, and Jiambalvo (1998), Beatty and Harris (1998), Beatty and Petroni (2002), Coppens and Peek (2005), and Burgstahler and others (2004) examined effect of auditor quality on earnings management in private firms and concluded that auditor quality had a negative relationship with earnings management in private companies.

Davis, Soo, and Trompeter (2002) in their research concluded that there was a negative significant relationship between auditor quality and earnings management. Tendeloo and Vanstraelen (2002) in their investigation inferred that there was a negative relationship between auditor quality and abnormal accruals. Hogan and Jeter's findings (1999) indicated that auditor quality reduced profit smoothing. In addition, results of investigation conducted by Zhou and Elder (2002) showed that companies, which were audited by five big auditing firms, had less earnings management. Bannister and Wiest (2001) concluded that auditor quality limited profit smoothing. Cameran, Prencipe, and Trombetta (2008) came to the conclusion that hours spent on auditing of client had a negative relationship with abnormal accruals and earnings management.

Results of research carried out by Gore, Pope, and Singh (2001) demonstrated a negative relationship between auditor quality and earnings management in initial public offering (IPO) process. Elder and Zhou (2001) in their investigation inferred that existence of auditing committee and its size decreased earnings management. Fairuzana and Rashidah (2006) in their research examined effect of auditing firm (the big five auditing firms) and existence of auditing committee on accruals. Their results showed that size of auditing firm did not reduce amount of abnormal accruals; however, existence of an active auditing committee in firm decreased its amount. Moreover, Ming (2007) through his research in Chinese firms concluded that ten big auditing firms in china caused a higher decrease in earnings management as compared to other firms.

Francis (1999) in his research came to this conclusion that firms with higher tendency more probably create accruals for using services of six big auditing firms for crediting their profits. Azibi and Rajhi (2008) in their investigation inferred that auditing of five big firms does not affect accruals decline. Results of a research carried out by Thoopsamut and Jaikengkit (2008) indicated that existence of auditing committee, number of its sessions and size of auditing firm did not affect earnings management. Furthermore, Chen (2005) concluded that auditing continuation of an auditing firm increased use of accruals and earnings management. Smith et al (2008) examined the relationship between internal auditor quality and earnings management. They selected 528 firms during time period of 2000-2005 for their experiment hypotheses. Their research results showed that high quality of internal auditing resulted in a decrease in earnings management.

Ebrahimi Kordlar and Seyedy (2008) in their research regarding 71 companies listed in Tehran Securities Exchange examined effect of type of auditing firm (auditing firm and other firms) and type of auditor's opinion in audit reports on abnormal accruals and concluded that there was a relationship only between type of auditing firm and abnormal accruals.

RESEARCH METHOD

The research topic is based on the question "Can professional auditing firms, which offer higher-quality services compared to other firms, limit earnings management?"

Therefore, time span of this research comprised a 4-year period in 2005-2008. The statistical population under study in this research included all the companies registered in Tehran Securities Exchange.

For selecting sample, the companies out of all existing companies, which did not have any of the following requirements, were removed from the list and; consequently, all the remaining companies were selected for conducting the experiment.

1) Fiscal year of company ends on March 20, each year.
2) It must not have changed its fiscal year during the research time period.
3) It must have had an active participation in Stock Exchange.
4) The information under question must be available for data extraction.

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5) It must not be an investing firm or a financial mediator.

Finally, after applying the above-mentioned limitations, 80 firms were selected for testing the hypothesis of existence of a significant relationship between auditor quality and earnings management.

Data in question were collected by gathering selected companies' data by using financial statements, explanatory notes, and using Tadbir Pardaz and Dena Sahm Softwares and financial data discs of stock companies. Cross-sectional regression method of each year and then cross-sectional regression with combined data and EVIEWS7 Software were implemented for data analysis and testing experiment hypotheses.

VARIABLES AND RESEARCH MODEL

Earnings management: In this research, abnormal accruals were used. In addition, three models were utilized for measuring earnings management. Afterward, the best model was selected using modified R^2. For estimating earnings management, first, Total Accruals must be obtained. Accruals were gained through the difference between operating-cash flow and net income.

$ACC= EARN- CFO$

The models used for estimating abnormal accruals (Earnings Management Index) included the following models:Jones's Model (1991)

$ACC_{it}=\alpha_0+\alpha_1 \Delta REV_{it}+\alpha_2 PPE_{it}+ \varepsilon$

In his model, ACC is equivalent to total accruals, ΔREV equivalent to income changes between the current year and previous year, PPE equivalent to properties, machinery, and equipment. All variables were divided by the total properties of the beginning of period.

Dechow et al.'s Model (1995)

$ACC_{it}=\alpha_0+\alpha_1[\Delta REV_{it}- \Delta REC_{it}]+\alpha_2 PPE_{it}+ \varepsilon$

ΔREC was equivalent to changes of accounts receivable changes between the current year and previous year.

Kasznik model (1999)

$ACC_{it}=\alpha_0+\alpha_1[\Delta REV_{it}- \Delta REC_{it}]+\alpha_2 PPE_{it}+\alpha3\Delta CFO_{it+} \varepsilon$

ΔCFO is equivalent to changes of operating cash flows.

The following model used for examining effect of auditor quality on earnings management (Piot and Janin, 2005).

$Abnormal\ Accruals= \beta_0+\beta_1 AUD+\beta_2 LnAssets+\beta_3DA+\beta_4ROA+ \beta_5Current+ \varepsilon$

Abnormal accruals: Absolute value of abnormal accruals and earnings management indicator. Abnormal accruals are calculated by Kasznik Method.

AUD: Auditor quality, which is defined as a dummy variable, namely, if auditing organization is independent auditor of firm, then it equals one, otherwise it equals zero.

LNASSET: Logarithm of total assets

ROA: Rate of assets output, which is obtained by dividing net profit by total assets

DA: Total Debts to Total Assets Ratio

Current: Current ratio and is equivalent to current assets divided by current debts

Significance Test of Regression Line Equation (Test F):

In multivariate regression line equation, if there is no relationship between dependent variable and independent variables, then all the coefficients of independent variables in equation must equal zero. Considering multivariate regression model, the decision-making rule is defined as follows:

$H_0: B_1=B_2=B_3=...B_\kappa=0$

$H_1=B_i\neq0$ $i=1,2,...,m$

(At least one of them is non-zero)

If at 95% confidence level, Statistic F calculated from regression equation gets bigger than F value obtained from chart, then Hypothesis H_0 is rejected, otherwise Hypothesis H_0 is accepted.

DURBIN-WATSON TEST

Durbin-Watson Test was used for serial correlation test in error terms. Durbin-Watson Test is based on first-order autocorrelated error model. This model is defined as follows:

$_t = P\varepsilon_{t-1} + V_t\varepsilon$

In above relationship, *P* is autocorrelation parameter with value of $-1\leq p \leq+1$ and V_t is independent variable with assumption of $V_t \approx N(0, \sigma^2)$. In this model, when p is positive, then autocorrelation is positive and when p is negative then there is a negative autocorrelation. At P=0 case, there is no autocorrelation. The following hypothesis was used for conducting Durbin-Watson Test:

$H_0: p = 0$

$H_1: p \neq 0$

Assuming p=0 means that there is not a serial correlation and the opposite assumption of p ≠ 0 namely serial correlation is true.

In the first phase, regression models for each of the test time periods are estimated separately. In the second phase, regression coefficients were estimated at a four-year level using combined data.

After estimation of each of these models, the model with the highest modified R^2 is selected as the desired model.

Results of chart (1) indicate that the modified R^2 of Kasznik Model is higher than those of other models. Hence, this model was used for estimating abnormal accruals.

CHART 1: SELECTION OF EARNINGS MANAGEMENT MODEL

Description	Modified R^2
Jones's Model	.044
Dechow et al.'s Model	0.11
Kasznik Model	0.226

Descriptive statistics include average, mean, standard deviation, maximum and minimum of all variables of research. The following chart shows descriptive statistics of all variables. Results of chart (2) indicate that only one fourth of all companies use services of high-quality independent auditors.

CHART 2: DESCRIPTIVE STATISTICS OF RESEARCH VARIABLES

Description	Average	Mean	The Highest	The Lowest	Standard Deviation
DA	0.675	0.675	1.767	0.23	0.195
LNASSET	5.639	5.607	6.899	4.058	0.335
ROA	0.121	0.109	0.575	-0.166	0.115
Abnormal Accrual	0.085	0.069	0.484	0	0.075
AUD	0.27	0	1	0	0.446
Current	1.167	1.145	3.743	0.093	0.477

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Chart (3) shows that there is a negative correlation between auditor quality and abnormal accruals. In addition, there is a positive correlation between current ratio and abnormal accruals. There is a negative correlation between current ratio, ROA, and debt ratio.

CHART 3: CORRELATION COEFFICIENT BETWEEN VARIABLES

Description	AA	AUD	LNASSET	DA	CURRENT	ROA
AA	1					
AUD	-0.041	1				
LNASSET	-0.034	*0.291	1			
DA	-0.006	-0.074	**0.1182	1		
CURRENT	*0.204	-0.011	*-0.266	*0.594	1	
ROA	*0.257	**-0.127	**0.127	*-0.486	*0.464	1

*significance at 1% error level
**significance at 5% error level

In the following, results of hypothesis test were presented at combined data level in chart (4) as sample.

Statistic F and its significance level confirm the significance of model for hypotheses test. Results of Durbin-Watson Test indicate lack of autocorrelation between error terms. There is a negative significant relationship between auditor quality and abnormal accruals (earnings management indicator). Results at combined data level indicate that independent auditor quality can be effective in limiting activities of earnings management. There is a positive relationship between debt ratio and abnormal accruals. In other words, the higher the debts of companies get, the higher abnormal accruals are used by managers for inflating earnings. Moreover, there is a positive significant relationship between ROA and earnings management. There is a positive significant relationship between current ratio and earnings management. The obtained results are different from Smith et al.(2008), and Ming's (2007) results.

CHART 4: HYPOTHESIS TEST AT COMBINED DATA LEVEL

Description	Coefficient	Significance
C	-0.101	***0.068
AUD	-0.018	***0.054
LNASSET	0.01	0.22
DA	0.103	*0.001
ROA	0.203	*0.000
CURRENT	0.037	*0.000

* Significance at 1% error level
** Significance at 10% error level

This research was also conducted at cross sectional level of 2005-2008 through which the following results were achieved:

Auditor quality is a two-value dummy variable. In this variable, auditing firm and other firms have values of one and zero, respectively. Research hypothesis was tested using cross-sectional regression in each year and implementing combined data. Results of research at cross section of each year in year 2008 were significant at 10% error level. In addition, results of hypothesis testing at combined data level using cross-sectional regression indicated significance of relationship between auditor quality and earnings management.

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In this age of Commerce, Economics, Computer, I.T. & Management and cut throat competition, a group of intellectuals felt the need to have some platform, where young and budding managers and academicians could express their views and discuss the problems among their peers. This journal was conceived with this noble intention in view. This journal has been introduced to give an opportunity for expressing refined and innovative ideas in this field. It is our humble endeavour to provide a springboard to the upcoming specialists and give a chance to know about the latest in the sphere of research and knowledge. We have taken a small step and we hope that with the active co-operation of like-minded scholars, we shall be able to serve the society with our humble efforts.

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